Supreme Court, U.S.
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80-481

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1980

NO.

PAUL KALMANOVITZ,

Petitioner,

vs

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

APPENDIX

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UNITED STATES DISTRICT COURT

DISTRICT OF COLUMBIA

SECURITIES AND EXCHANGE COMMISSION,)

PLAINTIFF,)

VS)

FALSTAFF BREWING CORPORATION,)

DEFENDANT.)

No. 77-894

PRELIMINARY STATEMENT

On August 1, 1977, this Court on motion of the Securities and Exchange Comission, granted a preliminary injunction restraining the defendants Falstaff Brewing Corporation and Paul Kalmanovitz from engaging in activities deemed to be in violation of the securities laws of the United States and regulations promulgated thereunder.

A hearing on the merits was held March 13-17, 1978. In addition to the live testimony adduced at that hearing, other testimony taken by deposition or in related proceedings, and numerous exhibits pertinent thereto, were made a part of the record.

On the basis of the whole record the Court, by Judgment annexed hereto, permanently enjoins Falstaff and its officers and agents from engaging in activities deemed to be violative of the securities laws of the United States and regulations promulgated thereunder.

In support of that Judgment, and pursuant to the requirements of Rule 52 Fed. R. Civ. P. the Court sets out hereinafter its Findings of Fact and Conclusions of Law.

FINDINGS OF FACT

Part I - BACKGROUND

1. Defendant, Falstaff Brewing

Corporation ("Falstaff" or "Company") is a Delaware corporation with its principal place of business at 470 10th Street, San Francisco, California. At all times prior to July 1975, the common stock of Falstaff was traded on the New York Stock Exchange, Falstaff's common stock is currently traded in the over the counter market. Falstaff has aprpoximately 4.5 million shares of common stock outstanding which are held by approximately 15,000 persons and 100,000 shares of Class A convertible preferred stock which are all beneficially owned by defendant Paul Kalmanovitz ("Kalmanovitz"). The common stock of Falstaff is registered with the plaintiff Securities and Exchange Commission ("Commission") pursuant to section 12 of the Securities Exchange Act of 1934 (15 U.S.C. §781)[Exchange Act]. Falstaff files

various reports and proxy soliciting materials with the Commission pursuant to the Exchange Act at the Commissions's offices in Washington D.C.1

2. Since April 28, 1975-with the exception of a brief period in 1976-Kalmanovitz has been and is presently chief executive officer and Chairman of the board of Falstaff. On April 28, 1975, Kalmanovitz became the beneficial owner of 100% of Falstaff's Class A preferred stock; and at all times since then Kalmanovitz's beneficial ownership of Falstaff's preferred stock has entitled him to 52% of the voting rights of Falstaff.2

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1 Answers of Falstaff Brewing Corp. and Paul Kalmanovitz ("Answers") ¶10 of plaintiff's Complaint ("Complaint").

2 Answers ¶13, admitting ¶ of Complaint in relevant part.

3. Ferdinand J. Gutting ("Gutting") was Chairman of the board, president and chief executive officer of Falstaff prior to April 28, 1975. 3

4. James S. McClellan ("McClellan")was, prior to April 28, 1975, a director of Falstaff, a member of the executive committee of the board of directors and outside legal counsel to Falstaff.4

5. Gutting and McClellan were named as defendants in the instant lawsuit. They each consented to the entry by this court of orders of permanent injunction at the time that the complaint in this action was filed.

6. For the year ending December 31, 1974, Falstaff reported losses in its

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3 Answers ¶12 admitting ¶12 of the Complaint in relevant part.

4 Answers ¶11 admitting ¶11 of Complaint in relevant part; McClellan, Reporter's Transcript of Trial Testimony ("RT") 23 (1-25).

Annual Report on Form 10-K ("Annual Report") in the amount of $3.8 million, and for the year ending December 31, 1975, Falstaff reported losses in its annual report in the amount of $8.5 million. 6

6A. The means and instrumentalities of interstate commerce were used in connection with the activities alleged in the Complaint. 6A

Part II. THE 1975 PROXY STATEMENT

A. Introduction

7. Falstaff and Kalmanovitz entered into an agreement as of March 10, 1975, whereby Kalmanovitz agreed to buy, for $10 million, 100,000 shares of a new class of convertible preferred stock to be issued by Falstaff. Each share of this "Class A" preferred carried sufficient voting rights so that if the transaction was approved by Falstaff's

shareholders. Kalmanovitz would control 52 percent of the voting rights of the company. Shareholder approval was required to authorize the new class of preferred and the March 10 agreement so provided. 7

8. The transaction was submitted to Falstaff's shareholders in Falstaff's 1975 Proxy Statement, which was mailed on March 31, 1975 and which scheduled the annual shareholders meeting for April 28, 1975. 8

9. At the shareholders meeting the agreement with Kalmanovitz, which had been favorably recommended by management, was approved, and stock was issued, and Kalmanovitz effectively took over Falstaff's corporate reins. 9

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7 PX, 56; McClellan RT 68(4)-69(2),77(16)-78(4).

8 PX 1.

9 PX1; McClellan RT 89 (21)-90(2).

B. The Continental Can Company Transaction.

10. A precondition to Kalmanovitz's investment in Falstaff ws the generation of sufficient capital to pay off all of the high interest (one and one-half percent over prime, or approximately 11 percent in early 1975) bank debt owed by Falstaff, which amounted to $16.5 million. He viewed this interest rate as a "cancer" and insisted that the debt be retired in advance of its normal maturity. 10

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10 Gutting RT 201(17-21) 206(13-19); Hoover Deposition ("Hoover") 22(19-23); Kalmanovitz Investigative Deposition ("Invest") 113(8-9); Kalmanovitz Deposition in Falstaff v. New York Life Ins. Co. et al. U.S.D.C. N.D. Cal. No. C75-1560 CFP ("NYL") (III) 50(27-26); 51(9-11); Kalmanovitz nYL (VIII) 327(26) 328(8) Tonna 118(15-25); Kalmanovitz RET 543 (16-20); Kalmanovitz RT J 543(16-20); 543(25) 544(5); 459 (2) 644(24) 645(5) 646(8-11).

11. Initially, Kalmanovitz agreed to invest $5 million in Falstaff preferred stock if Falstaff's suppliers would put up an additional $15 million. 11a This would have resulted in a total influx of $20 milion in cash-enough to pay off the high interest bank debt and leave a little for working capital. Kalmanovitz insisted on obtaining voting control of Falstaff as a term of his investment. 11b

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11a McClellan RT 46(2)-47(18), 53(7) -54(15); Tonna 36(19) 37(9), 39(22) - 40(6), 42(11) - 43(15); Gutting Rt 201 (17-21); 203(11-19); PX 36; PX 39; Hoover 23(3-6), 26(21) - 27(21); PK RT p. 547(2-14).

11b McClellan RT 55(6-17); 60(4-9); Gutting RT 206(1-13), 211(8) - 212(6); Kalmanovitz Deposition in Calhoun v. Falstaff, et. al., U.S.D.C. E.D. Mo. No. 76-246C(c) ("Calhoun")I 60(4-20); Kalmanovitz (invest.) 73(22) -74(5); Tonna 51(7-17); Hoover 33(11-15); 34(17-20); 36(3) -37(4).

12. Kalmanovitz could only interest one supplier in participating in any major way, and that one-Continental Can-refused to buy stock or to loan money outright. 12a Rather, at a meeting on March 8, 1975, Fred Hoover, a Vice-President of Continental, proposed on behalf of Continental, to extend Falstaff approximately $10 million in credit, in the form of deferrals on can payments, the balance to be put on a long term note personally guaranteed by Kalmanovitz and his wife. 12b while Hoover did not have final authority on March 8th to commit Continental to this proposal, he told Kalmanovitz that Continental's management probably would approve it. 12c As a result, Kalmanovitz reasonably believed that

12 a Hoover 38(2-5); Tonna 139(2-6).

12 b Hoover 37(1) - 91(20); Kalmanovitz RT 555(21) 556 (2).

12 c Hoover 91(4-11).

Continental would extend $10 million in credit to Falstaff on the terms discussed. 12d

13. Accordingly, on March 9, 1975, Kalmanovitz agreed to increase his own investment in falstaff to $10 million, so that in the end there would still be $20 million capital infusion needed to pay off the high-interest bank debt. 13a At a meeting held on March 22, 1975, the mechanics of the Continental extension of credit were worked out. By the end of the March 22nd meeting both Hoover 13b and Kalmanovitz 13c were of the opinion that an agreement had been reached

12d Kalmanovitz RT 556(3-14, 22-25).

13a Gutting RT 213(15) -214(17); McClellan RT 62(19) -46(15) -67(3-11); McLaughlin 8(9-14); 9(19-23) Percy 34(3-19); PX 49; 36(7-14); Tonna 100(1) - 102(10); 108(17) - 109(6); 137(10) - 138(1); Kalmanovitz RT 557(1) - 558(1); 558 (24) - 559(5); 677(20) - 678(4); 678(14-16).

13b Hoover 121(8-18); 125(14-24); 127(25) 129(2) - 131(217).

13c Kalmanovitz RT 568(11) 570(11).

whereby Continental would extend up to $10 million in credit to Falstaff payable in two years subject to Kalmanovitz's assumption of control of Falstaff. The Continental credit was thus an essential element of Kalmanovitz's investment in Falstaff and he so viewed it. 13d

14. However, because the Continental credit would only generate case as Falstaff let can bills build up over a four-month period, Kalmanovitz did not have, up front, $20 million in cash to buy 200,000 shares of $100 par value preferred stock, as had been contemplated in earlier drafts of his agreement with Falstaff. 14a But he still insisted on having numerical voting control of the company. 14b This could be done by

13d Kalmanovitz(Calhoun) I 186(15) - 187(24); 192(7-17); Kalmanovitz (NYL) VII 223(24) - 224(2); Kalmanovitz RT 646(8-11).

14a PX 42; McClellan RT 57(6) - 59(5); 59 (13-19); 62 (5-18); Kalmanovitz RT 553 (10-16).

14b McClellan RT 64(18) 65(3); Tonna 101(7) - 102(16).

doubling both the voting rights and the conversion ration on the $100 preferred, so that buying only 100,000 shares would give Kalmanovitz control. However, this was not a practical solution, as it would result in valuing Falstaff's common stock at $2.25 per share, half the price Falstaff believed would be "fair." 14 c

15. To resolve the dilemma, Falstaff agreed to double the voting rights on the preferred but left the conversion ratio unchanged. 15a Kalmanovitz was to buy 100,000 shares of this "Class A" preferred for $10 million in cash. In addition, Kalmanovitz was to get an option to buy 100,000 shares of a

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14c McClellan RT 58(8-17); 59 (20-25); Gutting RT 211(12-15); 212 (3-9).

15a Gutting RT 215 (2-8); McClellan RT 64(18)- 65(3); PX 46.

non-voting "Class B" preferred (carrying the same conversion ratio as the "Class A") for an additional $10 million. As consideration for this option, Kalmanovitz agreed to guarantee up to $10 million of Falstaff's accounts payable. This guarantee was separate and distinct from his guarantee of the Continental credit and would not result in any cash flowing into the Company. 15b

16. The net result of the foregoing was that Kalmanovitz and Falstaff were in the same position, vis-a-vis control, as if Continental had agreed to make a $10 million equity investment in the company, and Kalmanovitz had the $20 million he wanted to prepay the high interest bank debt. However he would have to wait until mid-summer of 1975 to complete

15b McClellan RT 65(22) - 66(9); PX 46.

the pre-payments as the cash generated by the Continental credit built up to the necessary levels. 16

17. The existence of the Continental extension of credit was not disclosed in the 1975 Proxy Statement.

17a. Kalmanovitz advanced $3 million towards the purchase price on March 13, 1975 and on March 18, 1975, agreed to subordinate this money, at the lenders request, to Falstaff's outstanding debt. 17a

18. During the period from April through August, 1975, pursuant to the Kalmanovitz-Continental agreement, Falstaff did not pay current Continental invoices for can shipments. These def-

16 Gutting RT 220(24) - 221(11), 406(3-10); Hoover 198 (8-13); 199(4-18); PX 48.

17a Gutting RT 217(17); 218(17), 219(22) - 220(8).

erred invoices totalled approximately $11.6 million on or about August 16, 1975. 18a On or about August 16, 1975, Kalmanovitz, on behalf of Falstaff, signed a two year note with Continental for approximately $11.6 million. This note was pesonally guaranteed by Kalmanovitz and his wife. Within five months of its signing, by the end of December 1975, Kalmanovitz and Falstaff prepaid all of the Continental note. 18b

C. Loan Prepayment Restrictions

19. Kalmanovitz consistently was determined throughout his negotations with Falstaff, to prepay the high-interest bank debt.[19a] Both the March

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18a Answers, ¶52, admitting ¶52 of Complaint in relevant part.

18b Kalmanovitz RT 588(3-25).

19a Tonna 118(15-18); Gutting RT 406(3-10); McClennan RT 55(20); 56(5); Percy 36(7-14); 99(1-18); PX 54; Falstaff Memorandum in Opposition to Preliminary Injunction ("Falstaff Opposition Memo") at p. 63.

10 Agreement 19b and the 1975 Proxy Statement 19c disclosed that the proceeds of the Kalmanovitz investment would be used to pay the bank loans. At the time, Falstaff owed additionally some $12.5 million to insurance companies. It was low-interest debt (6%) which Kalmanovitz considered an asset and hence had no desire to pay off. 19d

20. As of January 20, 1975, the banks and insurance companies to which Falstaff was indebted entered a so-called "Collateral Agency Agreement." The agreement provided that all prepayments by Falstaff on any of its loans would be shared by all of the lenders on a pro rata basis. 20

19b PX 46.

19c PX 1.

19d Tonna 118(15-25); 181(16-22); Kalmanovitz (NYL) 11 46 (1-5); Kalmanovitz (Antitrust) 782 (18-19); PX 54.

20. PX 33, Section 21.

21. Although Falstaff was not a signatory to the Collateral Agency Agreement, the Falstaff Board of Directors approved it on January 27, 1975. 21

22. Between 1970 and 1974 Falstaff, on numerous occasions, had been in default on its loan agreements. It was in default on its loan agreements. It was in default on these agreements on September 30, 1974. 22a Accordingly Falstaff agreed in November, 1974 in order to obtain waivers of the defaults, to grant security - i.e. mortgages- to its lenders on all of its fixed assets, excluding cash and receivables. 22b

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21 PX 34.

22a Answers ¶18, admitting ¶18 of Complaint; PX 21; Gutting RT 194(9-22); PX 25; PX27.

22b Answers ¶19 admitting ¶19 of Complaint in relevant part; McClellan RT 33(2-12); 34(16-25); 39(14) 40(18); Gutting RT 194(23) - 195(8); 196(16); 198(12-16); 207(6-8); PX 28; PX30; Tonna 31(9) 32(15); 35(15) 36(4); Answers ¶'s 20,21 admitting ¶20,21 of Complaint in relevant part.

23. Before renewing the waivers of defaults which had expired on March 15, 1975, Falstaff's insurance lenders made the pro rata payment restrictions contained in the Collateral Agency Agreement applicable to Falstaff by expressly requiring Falstaff to agree that no funds of Falstaff or any third party would be applied to the payment, purchase, or acquisition of any existing debt owed by Falstaff to any of the parties of the Collateral Agency Agreement except in equal pro rata proportion to such indebtedness. The insurance lenders further required Falstaff to agree to their right to call their loans should the pro rata provision be violated. 23

24. Falstaff agreed to the conditions on the "march waivers" on March 31, 1975, including the pro rata PX50; PX51; Gutting RT 393(12) 394(19)

provision. 24

25. Kalmanovitz knew about the pro rata prepayment restriction in the Collateral Agency Agreement 25a and the mortgages 25b by March 10, 1975.

26. Kalmanovitz told Curtis Palmer, a friend and advisor, about the pro rata payment restrictions in the Collateral Agency agreement on March 13, 1975. 26

27. Kalmanovitz knew bout the pro rata prepayment restriction in the March waivers by April 4, 1975. 27

24 Gutting RT 396(15-2;); 480 (6-13).

25a Palmer 15(5-28); 16(11-13); 16(20); 17(3); 31(15-25); 32(7-14); 35(7-17); 39(13-18); Kalmanovitz (SEC) 89(26) 91(15); 92(10-17); 94(8-12); 112(28) 113(1); McLaughlin 18(8) 20(8); Tonna 181(1-12); 181(23) 182(14).

25b McClellan RT 41(19) 42(2) 54(16-24); 67(12); 68(3); McLaughlin 13(11-19); 14(22) 15(3); 15(6-17); Tonna 37(13) 38(11); 39(8-21); 134(10-19); Gutting RT 201(15-17); 207(6-8); 271(4-16); 440(7-13).

26 Palmer 15(5-28); 16(11-13); 16(20) 17(3), 31(15-25); 32(7-14); 35(7-17); 39(13-18); Kalmanovitz (SEC) 89(26) 91(15) 92(10-17); 94(8-12); 112(28) 113(1);

28. Despite the existence of the pro rata prepayment restriction in the Collateral Agency Agreement and the March waivers, and his knowledge thereof, Kalmanovitz did not alter his plan to prepay the high interest bank debt. 28

29. Omitted.

30. The 1975 Proxy Statement did not disclose the prepayment restrictions contained in the Collateral Agency Agreement or the March waivers, the fact that Falstaff's assets were mortgaged, or the fact that Kalmanovitz planned to ignore the restrictions and prepay the bank loans anyway.

31. Despite his knowledge of the

27 PX 79; Gutting RT 398(18) 399(4); 400(21) 401(9); 405(2-4); Kalmanovitz RT 590(22) 591(6); McClellan RT 70 (10) 71 (22); McLaughlin 20(9) 23(16); Tonna 287 (3) 289(19).

28. PX 54; Kalmanovitz RT 6748(7-11) Gutting RT 478(15-25); Percy 38(24) 39(10); 99 (1-21); Palmer 32(7-14).

prepayment restraints and the mortgages, in June 1975 Kalmanovitz informed Falstaff's lead bank that he intended to prepay the bank loans in full and that Falstaff would not make pro rata prepayments to the insurance lenders. 31a By August 1975 Falstaff and Kalmanovitz prepaid the bank loans in full. 31b These prepayments contravened the express terms of the March Waivers. 31c.

32. By letters of July 25 and July 30, 1975, both of Falstaff's insurance lenders declared defaults on their loans and demanded immediate payment of the entire principal

31a PX 86.

31b Kalmanovitz RT 623(23-24)

31c PX 33; PX 50; PX 51.

amounting to over $12.5 million in the aggregate. The prepayment of the bank loans was listed as an event of default by both insurance lenders. 32

D. Misrepresentations and Omissions in the 1975 Proxy Statement

1. As to the March 10 Agreement

33. The 1975 Proxy Statement made the following disclosure concerning the March 10 Agreement between Kalmanovitz and Falstaff:

ISSUANCE OF PREFERRED SHARES: REASONS THEREFORE: Pursuant to an agreement entered into as of March 10, 1975, and subject to approval of the holders of a majority of the issued and outstanding shares of comon stock, the Company has agreed to issue and sell to Paul Kalmanovitz of San Francisco, California, 100,000 shares of the New A Preferred stock at a price equal to the

32 PX 96; PX 97.

aggregate par value thereof, namely, $10,000.000. Mr. Kalmanovitz has agreed to purchase these shares and has further agreed to guarantee the payment of up to $10,000,00 of the Company's accounts payable. In return, the Company has agreed to grant him the option to purchase 100,000 shares of the B Preferred for $10,000,000 during a five year period. The guaranty will expire upon exercise of the option or at the date of its termination, whichever shall first occur. 33a

Three additional relevant facts were disclosed, viz., (a) that each share of preferred carried 45 votes, 33b(b) that there were 4,496,625 voting shares of Falstaff outstanding 35c and; (c) that if the stock purchases were approved, Kalmanovitz would have the right to name a majority of the Falstaff Board of

33a PX 1, Section 9, P.8.

33b ID., Section 8, P.7.

33c ID., Section 4, P.4.

Directors.

34. The 1975 Proxy Statement did not disclose:

(a) The Kalmanovitz had arranged a $10 million extension of credit by Continental to Falstaff which he and his wife would personally guarantee;

(b) That the Continental extension of credit was a material part of Kalmanovitz's agreement with Falstaff;

(c) That Kalmanovitz had promised additional Falstaff can business to Continental as part of his agreement with Continental. 34

35. The proxy also failed to disclose in a clear and informative manner:

(a) That, if the sale of preferred to Kalmanovitz was approved, Kalmanovitz would be in control of the corporation and would become Chairman of the board

34 Tonna 55(19) 56(6) 97(7-8); 206(1-6); Hoover 92(2-9)

of directors;

(b) That Kalmanovitz would receive voting rights representing 52 percent of the voting rights of the outstanding Falstaff stock;

(c) The extent and amount of dilution of common stock voting rights.

36. The 1975 Proxy Statement did disclose that the proceeds from the Kalmanovitz transaction would, to the extent not required as working capital, be applied to the payment and discharge of Falstarff's bank loans. The 1975 Proxy Statement did not, however, disclose that:

(a) by the terms of the March Waivers, Falstaff would be prohibited from making such prepayments on the bank loans without pro rata prepayments on tits insurance loans;

(b) there was a substantial risk

that the insurance lenders would declare a default on the approximately $12.5 million in insurance loan indebtedness, call their loans and seek to foreclose on Falstaff if Falstaff made non pro rata prepayments on the bank loans; and

(c) that Kalmanovitz intended to make non pro rata payments on the bank loans regardless of the risk.

37. The 1975 Proxy Statement did disclose that Falstafff had had difficulty in complying with certain conditions in its loan agreements and had been forced to request waivers thereof. 37a It did not disclose, however, that the company had been in default on its loan agreements since September 1974, and had been forced to seek a series of waivers from lenders since that time, all of which were expressly conditoned on Falstaff's agreement to pledge all of

37a PX1, Section 9, page 8.

its real and personal property to its lender as security for their loans; nor was the pledge itself disclosed. Further, the 1975 Proxy Statement did not disclose that the March Waivers-which Falstaff had signed-contained conditions which required, in part, that none of the bank loans, be paid down except on a pro rata basis; that no new extraordinary indebtedness, including the Continental credit, be incurred; and that the preferred stock to be sold to Kalmanovitz not be issued without the consent of the insurance lenders. 37b

2. Financial Statements Appended to the 1975 Proxy.

38. The 1975 Proxy Statement did not disclose the fact that General Brewing Company which was owned and controlled by Kalmanovitz, a nominee director of Falstaff, had entered into a product-

37b PX50; PX51.

ion agreement with Falstaff and had purchased Falstaff's San Francisco brwerey in October, 1974. 38

3. Financial Statements Appended to the 1975 Proxy.

39. Included in the 1975 Proxy Statement were financial statements for the year ended December 31, 1974. These financials:

(a) stated that violations of the covenants in Falstaff's loan agreements had been waived by the lenders; 39a but did not disclose the existence or terms of the conditions on said waivers.

(b) did not disclose that Falstaff had pledged all of its real and personal property to the lenders.

38 Answers ¶23, admitting ¶23 of Complaint in relevant part.

38a PX1, page 20, footnote 6.

(c) did not disclose the existence of the Collateral Agency Agreement or the requirement contained in the March Waivers of pro rata prepayments of Falstaff's bank and insurance loans.

(d) did not disclose that the $2.5 million note receivable from General Brewing Corporation for the sale of Falstaff's San Francisco brewery was a non-recourse note with limited sources of payment or that the note represented an indebtedness from a company owned by Kalmanovitz a nominee director of Falstaff. 39b

E. Kalmanovitz's Knowledge Regarding the 1975 Proxy Statement.

40. Kalmanovitz had a draft of the 1975 Proxy Statement in his possession as early as March 22, 1975, and on that date showed it to a Continental representative who reviewed it. 40a Prior to that meet-

39b Answers ¶23, admitting ¶23 of the Complaint in relevant part; Tonna 12(16) (23).

40a Hoover 132(22) 133(11); 133(19-25).

ing, Kalmanovitz and Continental had expressly agreed not to publicize their agreement. 40b

41. In addition, Kalmanovitz received a copy of the final Proxy Statement shortly after March 31. He read it, thought it was fraudulent, but "kept his mouth shut" because he had already put up his $3 million advance.41

42. Thus, Kalmanovitz, in advance of the annual shareholders meeting at which he was to obtain control of Falstaff, knew about mis-statements and omissions in the 1975 Proxy Statement regarding Continental and the lenders, was a nominee director therein, and had nominated three other proposed directors.42

40b Hoover 197(4-20); Tonna 264(15) 266(23).

41 Kalmanovitz (Antitrust) VII 582(24-28); 583 (3-26) 584 (14-22); 585 (7-16); (19-23); Kalmanovitz RT 652 (4-9); 658 (2-24); PX1, page 1

42 PX1, Section 4, page 4.

PART III. FALSE MISLEADING AND UNTIMELY REPORTS FILED WITH THE COMMISSION BY FALSTAFF AND KALMANOVITZ AFTER APRIL, 1975.

43. During the period from April 1975 to the present, Falstaff has filed with the Commission at its offices in Washington, D.C. numerous annual and periodic reports pursuant to Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 and 13a-13 promulgated thereunder, including Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. 43

44. During the period from April 1975 to the present, Falstaff has filed with the Commission proxy soliciting materials, in connection with annual and other meetings of shareholders of Falstaff, pursuant to Section 14(a) of the Exchange Act and the rules and regul-

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43 Answers ¶62.

lations promulgated thereunder. 44

45. After the Kalmanovitz take-over, Falstaff continued to file false and misleading reports with the Commission and failed to submit other required reports thus continuing to deprive the shareholders and the investing public of full and fair disclosure concerning the corporation.

46. Barry Murphy acted as corporate counsel for Falstaff from the summer of 1975 until his departure from Falstaff in August 1977 with the exception of a few months in early 1976. He was member of the board of directors of Falstaff from September 1975 to July 1976 and acted as secretary to the corporation during approximately the same period. Murphy participated in the drafting of the majority of reports filed with the Commission by Falstaff during the two year period he was at Falstaff. However, during this two year period Murphy was

44 Answers ¶63.

never on Falstaff's payroll-he was also serving as corporate counsel for General Brewing and was an employee of General Brewing, hence of Kalmanovitz. 46

47. Robert Sievers is a certified public accountant. He became treasurer of Falstaff and was appointed to the Board of Directors in August, 1976. From the beginning of his employment in March, 1976 to the time of his departure in November 1977, Sievers participated in the preparation of Falstaff's filings with the S.E.C. 47

48. Daryl McCurry is presently the controller for Falstaff. Since July 1976 McCurry has also had responsibility with respect to SEC filings by Falstaff. 48

A. Current Reports on Forms 8-K

49. Falstaff failed to file a Form 8-K disclosing the prepayments of the bank loans during the summer of 1975, nor

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46 Murphy 237(1) 288(10) 240(1) 241(4) Answers to Interrogatories ¶1 and Exhibit A.

47 Sievers RT 265(12-15) 266 (1-24) 268 (4-6) 271 (2-9).

did Falstaff disclose that these payments violated terms of the March Waivers Agreement between Falstaff and its lenders.

49a. Falstaff failed to file a Form 8-K for July 1975 disclosing the fact that the insurance companies had declared over $12.5 million in loans in default and that the prepayments to the bank lenders had precipitated the declaration of defaults.

49b. Falstaff failed to file a Form 8-K to report that Falstaff had entered into a two year note with Continental for $11.6 million in August 1975.

49c. Falstaff failed to file a Form 8-K disclosing the reduction in long term indebtedness during October, November, and December, 1975, resulting from Falstaff's payments on the Continental

note.

50. On August 29, 1975, McClellan sent a letter to a lawyer working for Kalmanovitz, with copies to Kalmanovitz and Murphy, in which he expressed concern about Falstaff's compliance with the reporting requirements of the securities laws. He pointed out specifically that the loan defaults should be disclosed on a Form 8-K. 50

51. On November 10, 1975, Falstaff filed a Form 8-K for the month of October, but failed to disclose any of the events described in ¶'s 49-49(c) above including the declaration of defaults by the lenders, the acceleration of $12.5 million in principal payments, the bank loan prepayments, or the $11.6 million long-term Continental note. 51

52. The October 8-K wsa prompted by a letter written to Falstaff and the SEC

50 PX 107; McClellan RT 108(7-15), 109(1-2) 113(7-19).

51. PX 7; Murphy 403(8) 405(28).

by Haskins & Sells in which Haskins & Sells resigned as independent auditors and informed Falstaff that it would have to report the resignation in a Form 8-K. Kalmanovitz told Murphy to draft the October 8-K in response to Haskins & Sell's letter. 52

53. During the drafting of the October 8-K, Murphy discussed the items which should be included therein with Kalmanovitz and reviewed drafts with him. Although Murphy indicated that the rules required disclosure of loan defaults, they jointly determined not to disclose the defaults specifically because it was Falstaff's position that it had not defaulted on the loan agreements. They decided, instead, to disclose the defaults by describing lender related litigation. 53

53a. However, the October 8-K did

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52 Murpjy 360(13) 361(14), 362(8-12) PX 7, attached letter of 10/24/75.

53 PX 7; Murphy 364(2-1 2) 367(1-9), 385(25) 386(5), 387(15-27), 392(10) 393(14) 394(11-24).

not describe the litigation; it only set forth the case by name and number and indicated the case related to "financing". It gave no information about the alleged defaults or any other problems with the lenders. 53a

54. At the time the litigation record was compiled for inclusion in the 8-K, Murphy and Kalmanovitz knew that the Form 8-k rules required that Falstaff give a description of the significant items of litigation. 54

55. In response to comments by the SEC, Murphy prepared and filed another Form 8-K for January 1976. The January 8-K described the lender litigation and stated that when Falstaff made the prepayments on the bank loans the insurance companies threatened suit "based on Falstaff's failure to permit the insurance companies to share in these

53a PX 7.

54 Murphy 385(25) 387(14).

same prepayments according to prearranged terms set by the same companies. 55

55a. The 8-K did not disclose that Falstaff had agreed to the pro rata prepayment provisions contained in the March waivers, nor did it disclose the existence of the Collateral Agency Agreement, or the pro rata prepayment provisions which had been incorporated therein. The January 8-K further did not disclose that the foregoing agreements existed before the shareholders approved the sale to Kalmanovitz (which sale required that the proceeds be used to pay off the banks), and that Falstaff and Kalmanovitz made the prepayments to the banks with full knowledge that there was a substantial risk that default would be declared on th insurance loans. Kalmanovitz participated in the drafting of this specific disclosure. 55a

55 Murphy 413(11) 414(12); PX 9

55a Murphy 431(16-28)

B. The November 1975 Shareholders' Letter

56. In November, 1975, Kalmanovitz sent to Falstaff's shareholders a letter drafted by himself and Murphy which was false and misleading. The letter disclosed that Falstaff had prepaid the bank debt and stated the insurance lenders threatened Falstaff with a lawsuit based on "an agreement which the lenders had made between themselves". The letter did not disclose that the lenders had declared $12.5 million in indebtedness in default and immediately due and owing. Nor did the letter disclose that the "agreement" referred to (the Collateral Agency Agreement) was approved by Falstaff's Board of Directors. Of greater significance is that the letter omitted reference to the March Waivers wherein Falstaff had speci-

56 Murphy 399(2-22), 399(27) 400(7) 430 (10-19) PX120; Kalmanovitz SEC 276(16-25), 278(7-9), PX 50 & 51 (para.3).

fically agreed inter alia not to pay any signatory of the Collateral Agency Agreement other than on a pro rata basis. 56

C. The Annual Reports on Forms 10-K

57. In its annual report on Form 10-K for fiscal year 1975, Falstaff disclosed in the description of litigation that Falstaff's lenders were "claiming default under covenants of the original lending agreements and also a default resulting from an agreement dated March 25, 1975 requiring the company to pay off its long term lenders on a pro rata basis."

57a. The 10-K did not disclose that Falstaff's prepayments of its bank loans precipitated the declaratoin of defaults by the insurance lenders.

58. No attempt was made to correct

this misleading disclosure in succeeding reports-the Falstaff Form 10-K for 1976 contains the same disclosure regarding Falstaff's lender litigation as did the 1975 Form 10-K. 58

59. At the time that Falstaff was making its reports to the Commission and to the shareholders, Kalmanovitz considered that the pro rata prepayment restrictions, (which he considered to be unenforceable) would be a considerable threat to the financial stability of the company if ultimately found to be enforceable. 59

D. Adoption of False and Misleading Statements

60. Since April 1975 Falstaff and Kalmanovitz have failed to correct many of the misleading disclosures in the 1975 Proxy Statement, and have adopted the false and misleading disclosures therein.

58 PX 10, Item 5.

59 PX 114; PX 108 at pages 13-14, Kalmanovitz (SEC) 271 (28) 272(11); 273 (12-15)

61. In various reports filed with the Commission subsequent to the 1975 Proxy Statement, there have been discussions of the sale of Falstaff preferred stock to Kalmanovitz. Some of these reports make explicit cross reference to that portion of the original 1975 Proxy material dealing with increases in outstanding securities. Yet nowhere has Falstaff corrected the misstatements and omissions noted in ¶35(a)-(c) above concerning the effect of those share increases. 61

62. Moreover, as described below (¶63b), Kalmanovitz adopted the language of the 1975 Proxy Statement in describing his purchase of Falstaff preferred stock in his own personal filing of a Schedule 13D more than one year after the 1975 Proxy Statement was disseminated.

E. Kalmanovitz's Schedule 13D

61 Murphy 434 (18-28), 437(19) 438(7); PX 6, Item C; PX 8, Item 6; PX 11, Section entitled "Election of Directors"; PX 10, Footnote No. 8 to the financial statements.

63. By reason of his purchase of the Falstaff preferred stock in April 1975, Kalmanovitz was required by Section 13(d) of the Exchange Act to file a Schedule 13D setting forth specific information about his purchase within 10 days of his purchase.

63a. Kalmanovitz filed the required Schedule 13D over one year late, in May 1976. 63a

63b. The disclosure of Kalmanovitz's transaction with Falstaff in the Schedule duplicates word for word the description in the 1975 Proxy Statement concerning Kalmanovitz's purchase and thereby adopts the misleading disclosure of the 1975 Proxy Statement. 63b

64. In addition, the Schedule 13D failed to disclose, as required, certain disclosures of Kalmanovitz's source of

63a Answers ¶48.

63b PX 1, items 8, 9; PX 15, Item 4.

funds for the purchase.

65. Kalmanovitz filed the Schedule 13D only after a lawsuit was brought by a minority shareholder of Falstaff, alleging in part his failure to comply with the requirements of Section 13(d). 65

66. In his letter to the SEC enclosing the Schedule 13D, Kalmanovitz stated that his delay in filing the Schedule was caused by the fact that he was not familiar with the SEC requirements for such disclosure. 66

66a. However, Kalmanovitz had previously signed and filed a Schedule 13D with the SEC when he acquired control of General Brewing Corporation in October, 1971. 66a

Part IV. THE 1977 PROXY STATEMENT

67. On or about April 29, 1977, Falstaff filed with the Commission and

65 Kalmanovitz RT 627 (17-23) 663(13-16)

66 PX 131; See also Answers ¶48

66a PX 183.

mailed to shareholders of Falstaff, a proxy statement ("1977 Proxy Statement") pursuant to Section 14(a) of the Exchange Act and the rules and regulations thereunder, with respect to an annual meeting of shareholders of Falstaff to be held on June 7, 1977. 67

68. The 1977 Proxy Statement solicited proxies from the shareholders for the election of directors, including the re-election of Kalmanovitz, and for an amendment to the character of Falstaff which would permit Falstaff to pay Kalmanovitz dividends on his preferred stock in the form of common stock of Falstaff instead of cash. The preferred stock in question is the stock which was purchased by Kalmanovitz by means of the 1975 Proxy Statement. The proposed stock dividend had to be approved by a majority vote of both Falstaff preferred and

67 Answers ¶57.

common shareholders voting as separate classes. 68

69. The 1977 Proxy Statement states the following concerning the proposed charter amendment:

PROPOSED AMENDMENT TO THE CERTIFICATE OF INCORPORATION: On March 14, 1977 the Board of Directors approved an amendment of the Corporation's Certificate of Incorporation to permit the payment of common stock dividends on Class A and Class B preferred stock in lieu of cash dividends. Adoption of this proposed amendment requires the separate approval of each class of stock outstanding. Approval requires that a majority of the votes entitled to be cast by each class be voted in favor of such amendment. The purpose of this amendment is to allow the Corporation to provide preferred shareholders with a return on

68 PX3; Answers ¶58.

their investment without draining the working capital of the company. The Certification of Incorporation presently provides only for cash dividends to be paid to the preferred shareholders. As amended, the Certificate of Incorporation would permit the Corporation upon decision of the shareholders, to declare common stock dividends in lieu of cash dividends on the Class A and Class B preferres stock. The effect of the payment of such dividends, payable in common stock to the preferred shareholders, would be some dilution in ownership for the holders of common stock. It is the opinion of management that the adoption of this amendment will be highly advantageous to the company since it will allow the company to conserve its cash and working capital and maintain a stronger financial

position. Management highly recommends a vote in favor of this amendment. It is intended that shares represented by proxies in the accompanying form will be voted in favor of this amendment provided such proxies are not voted to the contrary.

The 1977 Proxy Statement also states that Kalmanovitz is the holder of 100 percent of the Class A Preferred stock and therefore has a direct interest in the proposed stock dividend. 69

70. The 1977 Proxy Statement failed to disclose the following:

(a) the beneficial ownership by Kalmanovitz of 52 percent of the voting rights of Falstaff;

(b) that Kalmanovitz controlled the company and the Board of Directors and therefore could dictate the Board of Directors' action on the granting of the

69 PX 3.

stock dividend;

(c) that while Falstaff "highly" recommended the amendment, there was a potential conflict of interest between Kalmanovitz and Falstaff concerning the transaction, in that Kalmanovitz's control of Falstaff might be significantly enhanced thereby;

(d) the intentions of the Board, if any, with respect to declaring the stock dividend in the current and succeeding years;

(e) the fact that there were existing restrictions on the payment of cash dividends (contained in the March 10 agreement) and whether they would apply to potential current or future stock dividends;

(f) the number and percentage of shares of common stock which Kalmanovitz would receive if the charter amendment

were adopted (at the approximate market price prevailing in April 1977, the stock dividend proposed would amount to 240,000 shares of Falstaff common or five (5) percent of the outstanding shares of common stock;

(g) a quantification of the dilution of Falstaff's common stock resulting from the proposed amendment;

(h) the value which would be assigned to the comon stock to be used as dividends and the current market value of the common stock (approximately $2.50 per share);

(i) the source of the common stock which would be used for the dividends-i.e. whether it would be purchased on the market, taken from treasury stock or taken from unissued stock of the corporation;

(j) the dollar amount ($600,000)

which would be paid to Kalmanovitz for the cash dividends on his preferred stock;

(k) pertinent financial data regarding Falstaff's cash and working capital showing that Falstaff's cash and cash equivalents as of December 31, 1976 were $15.6 million, although the stock dividend is recommended as being needed by the company to conserve cash and working capital;

(l) the facts concerning the transaction in 1975 between Falstaff and Kalmanovitz, the facts relating to the conflict with the lenders, and continental transaction and the consequences to Falstaff therefrom; and

(m) that the "audit committee" of Falstaff's Board, whose existence and membership was disclosed therein, had never functioned, and, indeed, had never

even met. 70

71. The 1977 Proxy Statement was primarily drafted by Sievers, McCurry and Murphy. McCurry, the primary draftsman, had never drafted a proxy statement before, was not confident of his ability to do so, and characterized his role as that of a "pencil pusher". He relied on Murphy for the adequacy of the disclosures. Both Sievers and Murphy reviewed drafts and commented thereon, although Murphy states that he never reviewed the proxy statement for SEC compliance because he was never asked to do so. 71

72. Kalmanovitz also received copies of the drafts of the 1977 Proxy Statement and suggested changes. 72

73. In the process of preparing the proxy statement, Falstaff considered disclosure of many of the significant

70 PX 3, page 5. See discussion below at ¶142 re the audit committee.

71 McCurry 38(14) 29(6); 60(9) 61(11) Murphy 227(9-20), 229(5-18), 235(18), 236(4) 276 (11-17) Sievers RT 277(5-14).

omitted facts discussed above but decided to withhold them from the proxy statement. Thus, although the amendment to Falstaff's charter which had been approved by the Board of Directors contained information concerning the method of valuation of the stock dividend and a description of the existing restrictions on Falstaff's ability to issue cash dividends, a specific decision was reached at Falstaff not to disclose all the information contained in the amendment. 73a So, too, consideration was given to disclosing (i) that Kalmanovitz owned 52% of voting rights of Falstaff 73b and (ii) that Falstaff had in excess of $15 million in working capital 73c and (iii) the diluting effect the proposed stock dividend would have upon the outstanding common stock. 73d In each instance, the information was

72 Sievers RT 277(5-18), 279(10) 280(11) 336(5-11), 337(9-16).

73a McCurry 33(5), 34(16-25) 35(1-4) 41(13-24), 42(11-19); Murphy 231(9-15), 232(4), 233(18), PX203, pagse 12

withheld despite the fact that, with respect to the dilution question, Sievers knew that the regulations specifically required disclosure of the dilution impact and McCurry thought that the dilution disclosure was not adequate and so argued. 73e

74. During the drafting of the Proxy Statement, McCurry became concerned about the qualifications of the Falstaff people to make required SEC disclosure. Accordingly, he suggested to Sievers and Murphy several times that someone more familiar with the SEC rules -i.e., qualified counsel-be brought in to review the 1977 Proxy Statement. His suggestion was rejected. 74

75. McCurry remained concerned that Falstaff personnel were not qualified to

73b McCurry 53 (23) 54(3)

74c McCurry 46(3-16), 49(6-18)

73d McCurry 30(9-13), 31(4-23), 32(5-22) 3395-10), (16-27)

73e McCurry 51(71-5), PX 156, page 3, Item #18

determine that the regulations had been complied with. The "only comfort" which he and Sievers thought they could find for the fact tha Falstaff did not have qualified legal counsel to review the proxy statement was that they thought it would be reviewed by the commission for defects when it was filed. 75

76. The 1977 Proxy Statement was filed with the Commission in preliminary form on or about March 28, 1977. Falstaff was advised on April 6 that the Commission would not give informal comments but that the proxy materials were materially deficient, and that if Falstaff disseminated it, it would be at its own risk. 76

McCurry 35(15) 36(21) 61(12) 62(19) 62(25) 63(8) 63(11-16).

75 McCurry 64(5-19); Sievers RT 282(6-24)

76 Murphy 281(2-14) 287(190 288(16) Dowd RT 527(8) 528(2) 528(;0-20); PX152; PX158 PX214

77. Commission regulations provide that the comment procedure is informal and that the Commission will not issue comments:

> Where the deficiencies appear to stem from careless disregard of the statute and rules or a deliberate attempt to conceal or mislead or where the Commission deems formal proceedings necessary in the public interest. 77

78. In response to the SEC objections, Falstaff added the following statement (the "Rider") to the 1977 Proxy Statement:

> In accordance with the rules and regulations of the United States Securities and Exchange Commission, this Notice of annual Meeting of Shareholders and Proxy Statement was submitted to the SEC in advance of mailing. The SEC has taken a 'no comment' position relative to

77 17 C.F.R. 202.3(a)

this proxy statement. The Company, in the interest of its shareholders, has proceeded with the mailing of this Proxy Statement without having received any formal comments from the SEC. In the event that the SEC later objects to any item or items to be voted upon, the votes as tabulated by the Company respecting any such item or items will not become effective until such time as such objections have been resolved.

The Rider does not disclose that the Commission had informed Falstaff that the proxy statement was materially deficient and that it would be sent only at Falstaff's peril. 78

79. The Rider was added at the express insistence of Kalmanovitz, who participated in its drafting, approved its final wording and directed that the proxy statement, as worded, be sent to

78 Murphy 281(2-14), 284(7), 286(2), 286 13-22), 287(19) 288(16); Answers ¶61; PX 162, page 2 ¶4.

Falstaff's shareholders. Sievers and McCurry were concerned that the Commission might still object to the form of the proxy statement after the Rider was included, but concluded they had been directed to issue the proxy statement in that form. 79

80. Falstaff mailed the 1977 Proxy Statement on or about April 29, 1977, more than three weeks after the Commission informed Falstaff that the Proxy Statement was materially deficient. During that time, Falstaff made no revisions to the originally drafted disclosure in the proxy statement, other than adding the Rider and changing the annual meeting date. No outside advice was sought by Falstaff as to the problems with the proxy statement and no attempt was made to redraft the proxy statement internally. In fact, while Falstaff

79 Murphy 284(7) 286(2), 505(9-20); McCurry 72(5) 73(2) 73(7) 73(23); Sievers RT 283(10-19), Kalmanovitz (SEC) 178(3) 179(4); Kalmanovitz RT 659(21) 660(2).

argues that at least one misleading statement in the 1977 Proxy Statement is simply a "grammatical error" not even this error was corrected before the final proxy statement was mailed. 80

81. On May 10, 1977, the staff of the Commission advised Falstaff that the Commission had authorized the filing of a complaint against Falstaff. Nonetheless, Falstaff continued to go forward with the 1977 annual Shareholders Meeting scheduled for June 7, 1977 and solicited proxies by means of the 1977 Proxy Statement until the commission filed a motion for preliminary relief on May 27, 1977. Falstaff then entered into a stipulatoin dated June 1, 1977 with the Commission the terms of which required Falstaff to postpone its annaul meeting and all solicitation of proxies until this Court's ruling on the Commission's

80 Murphy 282(6-14) 282(20) 283(2); Sievers RT 282(25) 283(2) 283(5-9); Answers ¶57. Falstaff memorandum in opposition to preliminary relief, page 55; Kalmanovitz (SEC) 180(15-22).

motion for preliminary relief. The Court entered a preliminary injunction against Falstaff on August 1, 1977. 81

PART V FORMS 3 and 4

82. Section 16(a) of the Securities Exchange Act of 1934 and the rules and regulations thereunder required all officers and/or directors of Falstaff to file a "Form 3" (Initial Statement of Beneficial Ownership of Securities) within ten days of their election disclosing whether or not they held Falstaff stock. It also required that changes in beneficial ownership be reported on Form 4 within 10 days following the end of the month in which the change occurred.

83. Kalmanovitz, who was elected a director of Falstaff on April 23, 1975, failed to file either a Form 3 or Form 4 until July, 1977. None of Falstaff's

81 McCurry 74(1-4); PX 162; Murphy 297(12) 298(5).

directors elected at the August 6, 1976 shareholders meeting filed a Form 3 or Form 4 until after July, 1977. 83

84. In the period between August 1976 and May 1977, Kalmanovitz purchased, beneficially, approximately 250,000 shares of Falstaff common stock, and transferred record ownership of his 100,000 shares of Falstaff preferred stock to his private companies, all without reporting the transactions to the Commission on a current basis. 84

85. At the time of their election to Falstaff's board in August 1976, several directors owned stock in Falstaff. Falstaff knew about the directors' stock ownership in 1976 but no review was made to determine whether the directors were required to make reports. 85

86. In July through September 1977, after the institution of this lawsuit on May 26, 1977, Sievers prepared and filed

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83 PX 18; McCurry 74(15) 75(12)

84 Id.

Forms 3 and 4 on behalf of Kalmanovitz and all the other Falstaff directors covering the entire period that they had been directors. 86

PART VI. DISREGARD OF DISCLOSURE RESPONSIBILITIES UNDER THE SECURITY LAWS

87. Since the Kalmanovitz take-over, Falstaff and Kalmanovitz have disregarded their responsibilities under the federal securities laws. In addition to the materially false and misleading reports and failures to report discussed above, the following factors further support the conclusion that without injunctive restraint there exists a reasonable likelihood that Falstaff and Kalmanovitz will continue to ignore and disobey the requirements of the securities laws.

A. Adequacy of Counsel

88. Since Kalmanovitz's take-over,

85 Murphy 457(7) 458(8) 464(9) PX 128; Hutton 160(15) 16(8); Sievers RT 300(1-12) 311(19) 312(16) 337(21) 338(3) PX 18.

86 PX 18, PX 169 and PX 173.

Falstaff has not made an adequate attempt to assure full and fair disclosure under the securities laws. For example, prior to this lawsuit, Falstaff did not have experienced securities counsel to review its reports or disclosure requirements. Moreover, the counsel at Falstaff, Murphy, told Kalmanovitz he was not qualified to monitor SEC compliance and that qualified counsel should be retained. This was not done, and Murphy continued to work on SEC filings in 1976 and 1977. 88

B. Adequacy of Accounting

89. In October, 1975, Kalmanovitz who was then disputing the accuracy of Falstaff's previous financial statements, represented in a letter to the SEC that Falstaff had hired new independent accountants to audit Falstaff's books and thereby enable Falstaff to file accurate

88 Murphy 348(14) 250(19) 440(5-26) 455(14) 446(11), 467(5) 468(1) Kalmanovitz (SEC) 183(22) 184(25) 186(2-28) Answer to Interrogatorires ¶5.

reports. In fact, Falstaff had not hired new independent accountants at that time.

90. At the urging of Sievers, an audit committee was appointed at the board of Directors meeting of September 29, 1976. The stated purpose of the audit committee was to review and approve the work of Falstaff's auditors. 90

91. Sievers believed the audit committee should be composed of outside directors. Although the minutes of the September Board meeting reflect that the audit committee consisted of "outside" directors, the directors chosen were Sievers, Garman and Nicholas Schleifer. Garman and Schleifer were employees of General Brewing which is 99% owned by Kalmanovitz. Kalmanovitz, Sievers and Murphy had discussed whether Schliefer and Garman were "independent" directors and had concluded they were. Clearly,

90 Sievers RT 313(15) 314(9); PX 201 Page 2 at ¶5-6.

Clearly, they are not. 91

92. Although the minutes of a subsequent Falstaff Board meeting state that the Board reviewed and approved "the activities" of Falstaff's audit committee, the audit committee in fact never met, never became operational, and had had no "acitvities" to review or approve. 92

93. Accordingly, Falstaff's statement in its 1977 Proxy Statement that it had an audit committee was misleading in that the committee existed in name only. 93

CONCLUSIONS OF LAW

I. Applicable Legal Principles

1. The Commission seeks to enjoin

91 PX 201 Page 2 at ¶5-6; PX 11, page 3 Kalmanovitz affidavit at ¶101; Murphy 156(16) 158(2) 160(4-10).

92 PX 203 Page 3 at ¶4; Sievers RT 316(4-9) 320 (2-22); Garman 47(14) 48(3) 49(23) 50(19).

93 PX 3, page 5; Sievers himself couldn't remember who the members of the audit committee were and made a note to look them up for disclosure in the proxy statement (PX 156, Page 3, Item 17).

Falstaff and Kalmanovitz from future violations of the federal securities laws. It seeks this relief pursuant to Section 21(d) of the Exchange Act [15 U.S.C. §78u(d)] which provides that the court shall grant a permanent or temporary injunction or restraining order upon a "proper showing" by the Commission. This test is satisfied where there is a showing that defendants' past conduct indicates a resonable likelihood of future violations by the defendants. See SEC v. Savoy Industries, No. 76-1490 (D.C. Cir. , July 14, 1978) at 36.

2. In an action involving "remedial" statutes such as the Exchange Act, a district court has broad discretion to enjoin possible future or present violations of law where past violations have been shown. SEC v. Koracorp Industries, Inc., 575 F. 2d 692,

701 (9th Cir. 1978); SEC v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1100 (2d Cir. 1972).

3. The standards governing the issuance of an injunction sought by the government for the protection of the public are necesarily broad and free from the more restrictive concepts employed in private litigation. When a federal court exercises its discretion in issuing a statutory restraining order or injunction, it is guided by the primary objectives of the statute involved, using the public interest as its guide post, rather than the requirements of private litigation. Superintendent of Insurance v. Bankers Life & Casualty, 404 U.S. 6, 12 (1971); Hecht Co. v. Bowles, 321 U.S. 321, 331 (1944). As the Supreme Court held in SEC v. Capital Gains Research Bureau, Inc. 375 U.S. 180 (1963), the

"mild prophylactic" relief of an injunction under the federal securities laws is not to be circumscribed by the more rigid standards which prevail at common law. Thus, it is not necessary for the Commission to show irreparable harm, or the inadequacy of other remedies or to post bond upon the granting of an injunction. SEC v. Management Dynamics, 515 F. 2d 801 (2d. Cir. 1975); SEC v. Tax Service, Inc., 357 F 2d 143, 145 (4th. Cir. 1966); But C.F. SEC v. Commonwealth Chemical Securities, Inc., 574 F. 2d 90, 99 (2d Cir. 1978).

4. The findings of fact demonstrate there have been violations of Sections 10(b), 13(a) and 14(a) of the Exchange Act [15 U.S.C. §§78j(b), 78m(a) and 78n(a)] and Rules 10b-5, 13a-1, 13a-11, 13a-13, 14a-3 and 14a-9 [17 C.F.R. §§240 10b-5 240 13a-1, 240.13a-11, 240.13a-13,

240 14a-3 and 240.14a-9] thereunder, and Rule 12b-20 [17 C.F.R. §240.12b-20] by both Kalmanovitz and Falstaff and of Section 13(d) of the Exchange Act [15 U.S.C. §78m(d)] and Rule 13d-1 [17 C.F.R. §240.14d] thereunder by Kalmanovitz himself.

5. The Commission has made a proper showing that there exists a reasonable likelihood that Kalmanovitz and Falstaff, unless enjoined and restrained, will violate the federal securities laws in the future.

6. In light of the showing made by the Commission of repeated past violations and of a reasonable likelihood of future violations by the defendants, the Court concludes that both Kalmanovitz and Falstaff should be enjoined from future violations of the anti-fraud, reporting and proxy provisions of the

Exchange Act.

II. VIOLATIONS OF SECTION 14(a)

7. Material facts necessary to be disclosed in a proxy statement are facts about which: . . . there is a substantial likelihood that a reasonable shareholder would consider it important . . . What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the . . . fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put anotehr way, there must be a substantial likelihood that the disclosure of the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976).

8. Failure to disclose material

information specifically required to be disclosed under Schedule 14A [17 C.F.R. §240.14a101 et seq.] violates Section 14(a) of the Exchange Act and Rule 14a-3 thereunder SEC v Kalvex, Inc., 425 F. Supp 310 (S.D.N.Y. 1975); SEC v. General Refractories Co., 400 F. Supp. 1248, 1257 (D.D.C. 1975).

9. The Commission has made a proper showing that proxy materials filed with the Commission pursuant to Section 14(a) of the Exchange Act and disseminated to Falstaff's shareholders were materially false and misleading and omitted to state material information required to be stated therein under the applicable rules and regulations of the Commission.

A. The 1975 Proxy Statement

10. Falstaff's transactions with Kalmanovitz, Kalmanovitz's control of Falstaff and potential conflicts of

interest with respect thereto, the Continental credit, and Falstaff's difficulties with its lenders, are all material facts which should have been but were not disclosed in Falstaff's 1975 Proxy Statement and which were necessary to enable stockholders to appraise their corporation and its management and vote their shares intelligently. The failure to disclose these facts rendered Falstaff's 1975 Proxy Statement materially false and misleading.

11. Item 7(f) of Schedule 14A required that the 1975 Proxy Statement disclose the Continental extension of credit and Kalmanovitz's and his wife's personal interest therein and the fact that the Continental extension of credit was a mterial part of Kalmanovitz's investment in Falstaff. The failure of the 1975 Proxy Statemetn to do so rendered it materially false and misleading.

12. Item 5(f) of Schedule 14A required that the 1975 Proxy Statement disclose the material fact that Kalmanovitz would be in control of Falstaff if the sale of preferred stock was approved. The failure of the 1975 Proxy Statment to do so, clearly and unambiguously rendered it materially false and misleading.

12a. The disclosure contained in the 1975 Proxy Statement concerning Kalmanovitz's control of Falstaff, requiring a shareholder to search out three critical facts which were set forth in separate sections and on various pages of the proxy statement, and to make mathmatical calculations in order to conclude that Kalmanvoitz would have numerical voting control of Falstaff, was not adequate to inform the shareholders of Kalmanovitz's control position. Buried disclosure is not adequate disclosre Feit v. Leasco Data Processing Equipment

Corp., 332 F. Supp. 544, 545 (E.D.N.Y. 1971); Gould v. American Hawaiian Steamship Co., 331 F. Supp. 981, 988-989 (D.Del. 1971) aff'd in relevant part, 535 F. 2d 761, 774 (3d Cir. 1976).

13. Item 12(d) of Schedule 14A required that the 1975 Proxy Statement disclose the material dilution effect on Falstaff's existing shareholders of the sale of stock to Kalmanovitz. The failure of the 1975 Proxy Statement to do so rendered it materially false and misleading.

14. The failure of the 1975 Proxy Statement to disclose the serious financial straits of Falstaff, including the facts that there had been a continuing default on the loan agreements and that Falstaff obtained waivers of the defaults by mortgaging its assets, made the 1975 Proxy Statment materially false and misleading. This informatin was particularly material in light of the

Kalmanovitz plan to prepay the bank loans.

15. The failure to disclose the pro rata prepayment restrictions regarding Falstaff's bank loans was also a mterial omission in that Kalmanovitz's prepayment plan put in jeopardy over $12.5 million in insurance loans, risked foreclosure on Falstaff's assets, and made possible lengthy, expensive and uncertain litigation with Falstaff's lenders. Falstaff and Kalmanovitz contend that the pro rata prepayment restrictions in the Collateral Agency Agreement and March Waivers did not have to be disclosed because they (1) violated the antitrust laws, (2) were improperly executed and, (3) in any event did not preclude prepayment. Even if these contentions were true, 15 they would not excuse the failure to disclose the existence of

15 On March 3, 1978 the District Court fort the Northern District of California entered summary judgment against Falstaff on these contentions. See Falstaff Brewing Co. v. New York Life Insurance Co. No. C- 1078 Falstaff entered

these restrictions and the terms thereof. The relevance of the restrictions were not their validity, but rather their existence and terms. It was the risk attendant to Kalmanovitz's plan to ignore these restrictions that had to be disclosed. In deciding whether to approve the sale of control to Kalmanovitz, Falstaff's shareholders were entitled to know the substantial downside risks inherent in Kalmanovitz's proposed infusion of capital into the company.

15a. Item 7(f) of Schedule 14a required that the 1975 Proxy Statement disclose the material October 1974 agreements between Falstaff and General Brewing. The failure of the 1975 Proxy Statement to do so rendered it materially false and misleading.

B. KALMANOVITZ'S LIABILITY UNDER SECTION 14(a) FOR THE 1975 PROXY STATEMENT.

16. To hold Kalmanovitz personally liable under §14(a) for the misstatements and omissions contained in the 1975 Proxy Statement is must be demonstrated that he either "solicited" or "permitted" the use of his name to solicit the proxy". The SEC has claimed to have established Kalmanovitz's personal liability under §14(a) under two separate theories.

16a. First, the SEC asserts that Kalmanovitz is liable as a principal in that he permitted the use of his name to solicit the 1975 proxy. Accordingly, we are required to face the rather novel question of whether the reach of §14(a) can be extended beyond the directors and officers of a company to the prospective buyer, when the solicitor of the proxy is the company itself.

16b. To hold a person liable under §14(a) for the use of his name in soliciting a proxy, it must be demon-

strated at the very least that a substantial connection between the use of the person's name and the solicitation effort existed. Yamamoto v. Omiya, 564 F. 2d 1319, 1323 (9th. Cir. 1977). The SEC points to the following factors to demonstrate such a connection: (a) Kalmanovitz was a director-nominee, (b) he was nominating three other directors and, (c) he was the sole beneficiary of the proposal in that it would yield him control of Falstaff. Kalmanovitz correctly points out that, at lesat as to the last factor, the mere appearance of one's name as the beneficiary of a proxy proposal, without more, does not constitute the use of his name to "solicit". Yamamoto, supra; Lewis v. Dansker, 68 F.R.D. 184, 194 N.2 (S.D.N.Y. 1975).

16c. However, in addition to being

beneficiary of the proposals, Kalmanovitz was also a director-nominee and was nominating three other directors. Hence, he had at least some duty to determine for himself the validity of the proxy materials submitted and to correct statements and facts which he knew or should have known were erroneous or misleading. Cf. Chris Craft Industries v. Independent Stock Committee, 354 F. Supp 895, 913 (D. Del. 1973). Further, the details of the Continental transaction, which was a material part of the proposal contained in the Proxy Statement as well as the details of the planned prepayment of the high interest debt was information which rested primarily with Kalmanovitz. Under such circumstances we find the necessary "substantial connection" between the use of Kalmanovitz's name and the solicitation effort to hold hiim indivi-

dually liable for violation of §14(a) and Rule 14a-9. 16c

C. The 1977 Proxy Statement

17. The many failures in the 1977 Proxy Staement to disclose material information including, among other things, Kalmanovitz's control of Falstaff, the terms and conditions of the proposed stock dividend, the significant enhancement of Kalmanovitz's control of Falstaff which could flow from the dividend and the potential conflict of interest position held by Kalmanovitz (in that he was the sole beneficiary of a plan which management, under his control, had recommended), rendered the 1977 Proxy Statement materially false and misleading.

16c The second theory under which the SEC asserts Kalmanovitz's individual liability under §14(a) is as an aider and abettor. To sustain this charge, the SEC must establish: (a) the doing of a wrongful act (b) Kalmanovitz's knowledge of it and (c) his knowledge and "substantial participation" in the wrongdoing. Gould v. American Hawaiian S.S. Co., 535 F2d 761, 779 (3d Cir. 1976). Our prior factual findings fulfill the first two of these elements. With respect to the third element, we view the circumstances discussed supra which lead to our conclusion that the use of Kalmanovitz's name had a "substantial connection" with the solicitation effort

misleading.

20. Items 12 and 13 of Schedule 14A required that the 1977 Proxy Statement disclose the following material facts in connection with the proposed charter amendment: the number, percentage and value of shares of common stock Kalmanovitz would receive, the source of the common stock dividend; the amount of cash dividends payable to Kalmanovitz; and information necessary to make the statement that the stock dividend would allow conservatoinof cash and working capital not misleading. The failure of the 1977 Proxy Statement to do so rendered it materially false and misleading.

21. The statement in the 1977 Proxy Statement regarding the existence of an audit committee of Falstaff's Board of Directors was materially false and misleading, in that the audit committee never met or functioned. The proxy statement thus falsely conveyed to Falstaff's shareholders the impression that effective oversight of their company's accounting functions was being exercised by the

Board of Directors.

22. The Rider to the 1977 Proxy Statement by disclosing only that "the SEC has taken a 'no comment' position relative to this proxy statement" omits to state the material facts that the SEC advised Falstaff that the Proxy Statement was materially deficient and that if sent in its then present form to shareholders, Falstaff would be doing so at its own risk. Falstaff's shareholders were thus deprived of the information that the Committee considered the proxy statement false and misleading in its then present form. [22] This material omission rendered the 1977 Proxy Statement materially false and misleading.

[22] The Rider which Falstaff attached to the 1977 Proxy Statement before mailing it to the shareholders does not prove its good faith. Indeed, the Rider undermines Falstaff's representations that it intends to comply with the federal securities laws in the future. Thus, the Rider has exacerbated the deficiencies already noted in the 1977 Proxy Statement. Rule 14a-4(e) requires that shares solicited by proxy be voted, subject to specified reasonable conditions. by conditioning the voting of proxies on highly speculative future events, the Rider to Falstaff's 1977 Proxy Statement violates Rule 14-a4(e) further demonstrating Falstaff's inability to comply on its own initiative with the requirements of the federal securities laws.

III. VIOLATIONS OF SECTION 13(a)

23. Section 13(a) of the Exchange Act (15 U.S. C. §78m(a)) is violated when a report required to be filed thereunder is materially false and misleading. SEC v. Great American Industries, Inc., 407 F. 2d 453, 457 (2d Cir. 1968) cert. denied, 359 U.S. 920 (1969); SEC v. Kalvex, Inc., supra at 316; SEC v. General Refractories Co., 400 F. Supp. 1248, 1257 (D.DC. 1975).

24. Pursuant to Rule 13a-1 under the Exchange Act, Falstaff is required to file an Annual Report on Form 10-K.

25. Pursuant to Rule 13a-11 under the Exchange Act, Falstaff is required to file Current Reports on Form 8-K.

26. Pursuant to Rule 13a-13 under the Exchange Act, Falstaff is required to file Quarterly Reports on Form 10-Q.

27. The Commission has proven that Annual, Quarterly and Current reports filed

with the Commission and disseminated to Falstaff's shareholders subsequent to April 1975 were materially false and misleading and did not contain material information required to be contained therein. This is so with respect to Falstaff's indebtedness before and after the 1975 sale of stock to Kalmanovitz, the prepayments of the bank loans, the declaration of defaults by the insurance lenders; the conversion of the Continental credit into long-term debt and the paydown thereof, and the material facts concerning the litigation between Falstaff and the lenders. Nor did the report correct the false and misleading disclosures in the 1975 Proxy Statement.

28. Items 8 of Form 8-K required that a Form 8-K be filed by Falstaff in 1975 disclosing the prepayment of the bank loans and the consequent possible violation of

the express terms of the Collateral Agency Agreement as they were incorporated in the March Waivers. The failure to file a Form 8-K disclosing these material facts constituted a violation of Section 13(a) of the Exchange Act, and Rules 13a-11 and 12b-20 thereunder.

29. Item 6 of Form 8-K required that a Form 8-K be filed by Falstaff in 1975 disclosing the declaration of default by the insurance lenders of $12.5 million in loans. The failure to file a Form 8-K disclosing this material fact constituted a violation of Section 13(a) of the Exchange Act and Rules 13a-11 and 12b-20 thereunder.

29a. Items 7 and 8 of Form 8-K required a Form 8-K be filed by Falstaff in 1975 disclosing both the entry by Falstaff into a two year $11.6 million note with Continental and the note's reduction by payment during October, November and December 1975. The failure to file such

a Form 8-K constituted a violation of Section 13(a) of the Exchange Act and Rules 13a-11 and 12b-20 thereunder.

30. Items 3 of Form 8-K and Rule 12b-20 required that Falstaffs Form 8-K for October 1975 disclose material information regarding legal proceedings between Falstaff and its lenders. The failure of Falstaff's Form 8-K for October 1975 to adequately describe this litigation rendered it materially false and misleading.

31. Rule 12b-20 required that Falstaff's form 8-K for January 1976, which disclosed the existence of litigation between Falstaff and its lenders, also disclose the material facts (1) that Falstaff had agreed to the prepayment restrictions in the March Waivers; (2) the Collateral Agency Agreement andits pro rata prepayment restriction; and (3) that Falstaff's prepayments to the

banks, made with knowledge of the prohibitions against them, precipitated the lenders' declaration of defaults. The failure of the Form 8-K for January 1976 to do so rendered it materially false and misleading.

32. Falstaff's Annual Reports on Form 10-K for fiscal year 1975 and 1976 violated Rule 12b-20 by omitting to state material facts regarding; (a) Falstaff's relations with the lenders; (b) the litigation with them; (c) the prepayment restirctions on the loans; (d) prepaymentof the bank loans; (e) declaration of defaults by the insurance lenders, and ; (f) the Continental transaction.

33. Rule 12b-20 required that the filings made by Falstaff with the Commission subsequent to the 1975 Proxy Statement correct the materially false and misleading disclosures contained in the 1975 Proxy

statement of provide the necessary additional disclosure to make the 1975 Proxy Statement not materially false and misleading. The failure of those filings to do so rendered them materially false and misleading.

IV. VIOLATIONS OF SECTION 10(b)

34. Falstaff's false and misleading disclosures in the 1975 Proxy Statement in Annual, Quarterly and Current Reports required them to be filed with the Commission subsequent thereto, in the November 1975 shareholders' letter, and in the 1977 Proxy Statement violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by concealing material facts from Falstaff's shareholders and the investing public with respect to the matters set forth above. Material facts within the meaning of Rule 10b-5 are those about which there is a substantial likelihood that a reasonable

investor would consider important in the making of an investment decision. TSC Industries v. Northway, Inc., supra at 449; Affiliated UTE Citizens v. United States, 406 U.S. 128, 153-154 (1972).

A. Necessity of a Finding of Scienter

35. The Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) held that a private cause of action will not lie under §10(b) and Rule 10b-5 without an allegation of scienter. However, it specifically declined to address the question of whether scienter is a required element in injunctive actions brought by the Commission. Id. at 194 n. 12.

36. Subsequently the Court in SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976) attempted to abandon the long standing Second Circuit rule that proof of past negligence will suffice to sustain an SEC injunction action [36a] by holding inter alia that Hochfelder required a showing of scienter in such cases. [36b]

However, in affirming the district court, the Second Circuit expressly declined to adopt that holding, basing its affirmance instead on the independent finding by the lower court that there was no likelihood of future violations, SEC v. Bausch & Lomb, Inc., 565 F. 2d 8, 14 (2d Cir. 1977).

B. Requisite Scienter Established

37. Like the Second Circuit, we too can leave for another day the resolution of the difficult question of whether scienter is a required element in SEC injunctive actions. For the evidence in this record amply establishes that Falstaff and Kalmanovitz filed reports with the Commission with such knowledge of the facts or reckless disregard for the truth that scienter, however that term may be defined by the cases, see, e.g.

36a See e.g. SEC v. Management Dynamics Inc. 515 F.2d 801, 809 (2d Cir. 1975); SEC v. Texas Gulf Sulfur Co., 401 F. 2d 833, 854-855 (2d Cir. 1968).

36b In SEC v. American Realty Trust, 1977-78 CCH Fed. Sec. L. Rptr. p.93,712 (E.D. Va. 1977), the Court also found scienter was required in such actions. This case is currently on appeal to the Fourth Circuit.

SEC v. American Realty Trust, CCH Fed SEc L. Rptr (77-78 Transfer Binder) p. 96,275 (2d Cir. 1977) at 92,772 has been amply demonstrated on the part of both Kalmanovitz and Falstaff.

38. Thus, Falstaff and Kalmanovitz knew of the existence of the misstatements and omissions of material facts in the 1975 Proxy Statement set forth in paragraphs 11 through 15A of these Conclusions of Law.

38a. Falstaff and Kalmanovitz also knew of the existence of misstatements in the 1977 Proxy Statement set forth at Paragraphs 17 through 22 of these Conclusions of Law.

V. KALMANOVITZ'S SCHEDULE 13D

39. The Commission has proved that Kalmanovitz violated Section 13(d) and Rules 13d-1 and 12b-20 by filing a Schedule 13D containing omissions of material fact required to be stated therein.

40. Kalmanovitz filed a Schedule 13D

(17 CFR §240.13d-101) regarding his purchase of Falstaff preferred stock pursuant to Section 13(d) of the Exchange Act and Rule 13d-1 thereunder on or about May 13, 1976.

41. Kalmanovitz's 13D violated Rule 13d-1, as it was filed more than one year after it was due.

42. Section 13(d)(1)B and E of the Exchange Act, Items 3, 5 and 6 of Schedule 13D and Rule 12b-20, required that Kalmanovitz's 13D disclose the material facts concerning the transaction with Continental. The failure of Kalmanovitz's 13D to do so rendered it materially false and misleading.

43. Section 13(d)(1)C, Item 4 of Schedule 13D and Rule 12b-20 required that Kalmanovitz's 13D disclose the material fact that he would acquire control of Falstaff as a result of his purchase of Falstaff stock. The failure of Kalmanovitz's

13D to do so rendered it materially false and misleading.

44. Item 6 of Schedule 13D and Rule 12b-20 required that Kalmanovitz's 13D disclose the material facts concerning the pro rata prepayment restrictions of the Collateral Agency Agreement and March Waivers; Kalmanovitz's intentions to prepay the bank loans despite these restrictions and the substantial risk that the insurance lenders would declare a default on their loans and accelerate the payment of principal thereon if prepayments were made. The failure of Kalmanovitz's 13D to do so rendered it materially false and misleading. [44]

[44] It is obvious that a number of the disclosures required by Item 6 had already occurred by the time Kalmanovitz late filed his Schedule 13D on May 13, 1976. For instance, the bank loans had already been prepaid and the insurance lenders had already declared a default on their loans. However, Kalmanovitz should have recorded this information in a form which would have been accurate if he had filed Schedule 13D in a timely manner.

45. Item 3 of Schedule 13D and Rule 12b-20 required that Kalmanovitz's 13D disclose the material facts concerning the source of funds used by Kalmanovitz in making the purchase of Falstaff's stock. The failure of Kalmanovitz's 13D to do so rendered it materially false and misleading.

45a. Kalmanovitz knew the facts which were omitted from his 13D.

VI. REASONABLE LIKELIHOOD OF FUTURE VIOLATIONS.

46. The standard to be applied in determining whether to issue injunctive relief is whether there is a reasonable likelihood of future violations. United States v. W.T. Grant Co., 345 U.S. 629, 633 (1953); SEC v. Aminex Resources Corp., supra, SEC v. Penn Central Co., 425 F. Supp. 593, 596 (E.D. Pa. 1976).

47. As noted by the Court in SEC v. National Student Marketing Corp., 360 F. Supp. 284, 297 (D. DC. 1973).

The case law identifies several factors which are deemed relevant to the probability of recurrent violations. The character of thepast violations, the effectiveness of the discontinuance and the bona fides of the expressed intent to comply are considered. The number and duration of past wrongs, the time which has elapsed since the last violation, the opportunity to commit further illegal acts, the novelty of the violation, and the harmful impact of the innunction on the defendant are objective factors which the courts have examined. Subjective inquiries into the willfulness or bad faith in a defendant's prior conduct and the sincerity of his representations not to violate the law are also pertinent. (cites omitted)

48. Regarding the number, duration and character of defendants' past violations, our discussion supra of these factors indicate that they have not been isolated

or random, but have rather been part of a chronic pattern of violations, which has continued up to the present time. As a result, neither of the defendants can take solace from cases which appear to suggest that isolated violations of the law may not warrant a finding of reasonable likelihood of future violations. See, e.g. SEC v. Commonwealth Chemical Securities, Inc., supra; SEC v. Bausch & Lomb, Inc., supra.

49. As for the subjective inquiry into the willfulness of defendants, prior conduct, we view the following factors as suggestive of a reasonable likelihood of future violations:

(a) The fact that Kalmanovitz and Falstaff continued to solicit proxies for the 1977 annual meeting even after being put on notice of the Commission's suit challenging the solicitation of proxies by means of the fraudulent 1977 Proxy

Statement, demonstrates the egregiousness of the defendants' violations and disregard for the federal securities laws.

(b) The fact that Falstaff sent out its 1977 Proxy Statement to shareholders in spite of (1) the warning by the Commission of the inadequacy of the proxy statement and the risks to Falstaff of its mailing, and (2) the concern expressed by Falstaff's own employees charged with preparing filings as to the adequacy of the proxy statement, provides ample proof of Falstaff's lack of regard for compliance with the securities laws.

(c) None of the directors of Falstaff's board, including Kalmanovitz, who have served under his chairmanship, filed the reports (Forms 3 and 4) required by Section 16(a) (15 U.S.C. §78p(a)) of the Exchange Act and the rules thereunder (17 CFR §240. 16a-1 et seq.) regarding their ownership

and transactions in Falstaff stock until after this suit was brought - these required forms were thus filed between one and two years late. While this has not been charged by the Commission as a substantive violation, it is compelling support for the reasonable likelihood of future violations, especially in light of the fact that those forms were not filed during a time when, if from no other source, Kalmanovitz and the directors should have become sensitized to the requirements of the federal securities laws from the existence of the Commission's investigation.

(d) Kalmanovitz's false representation to the SEC in a letter of October 15, 1975 that Falstaff had hired new independent auditors to rectify purported inadequacies in Falstaff's June 1975 Form 10-Q is particularly probative of reasonable likelihood, as this false statement was made to the agency enforcing the laws

which Kalmanovitz seeks to assure the Court he will comply with in the future.

(e) Kalmanovitz sent Falstaff's shareholders a false and misleading letter in November 1975, well after he took control of Falstaff which concealed from the shareholders: (1) the facts that Falstaff had approved the Collateral Agency Agreement and signed the March Waivers, (2) that the insurance lenders had declared defaults on their loans, and which, (3) misrepresented to shareholders the circumstances surrounding the dispute between Falstaff and its lenders the cause of which dispute was the very risk which went undisclosed in the 1975 Proxy Statement.

(f) The 1977 Proxy Statement informed shareholders of the existence of an audit committee of Falstaff's Board of Directors and of that committee's membership despite the fact that the committee never met and contrary to the impression conveyed to the shareholders, exercised no oversight

function.

(g) Falstaff falsely represented to this Court, in a July 1, 1977 letter, that the initiation of the Commission's suit against it caused the cancellation of its brewer's bond.

(h) The failure by Falstaff under Kalmanovitz's stewardship to inquire further into, review in greater detail, or take affirmative steps to comply with the disclosure requirements of the securities laws, even when faced on two separate occasions with the discovery of previously unknown requirements or deficiencies, does not inspire confidence that serious efforts to comply with the laws will be made in the future.

VII. NECESSITY OF COMMISSION COMMENTS.

50. Falstaff contends that the misleading statements and material omissions

in the 1977 Proxy Statement resulted from the failure of the Commission to comment on the Proxy Statement. These arguments are without merit. The defendants do not have the right to rely on the Commission's assistance to tell them how to comply with the securities laws, nor can they successfully assert the absence of such assistance as a defense. SEC v. Guaranty Bond and Securities Corp., CCH Fed. Sec. L. Rep. ('70-'71 Transfer Binder) p.92,928 (M.D.Tenn. 1971). It is clear, in the first instance, that the staff expressly advised Falstaff that it considered the 1977 proxy to be false and misleading and that it would be forced to take action if the proxy were sent to Falstaff's shareholders in its then present form. Despite this advisement, Falstaff's management mailed the proxy as is, without even making correction of errors previously argued by Falstaff to be "grammatical" in nature, adding only the Rider, which itself violated the proxy rules. Falstaff

has shown no reason for such precipitate action and has no demonstrated that degree of good faith which has led some courts to deny injunctive relief despite a finding of past violations of the securities laws. See SEC v. Harwyn, 326 F. Supp. 943 (S.D.N.Y. 1971).

51. Falstaff was not entitled to receive comments from the Commission's staff with respect to its deficient filings, 17 CFR §202.3(a), and, as McCurry testified, it knew this. The obligation to file accurate reports is entirely the registrant's and this obligation cannot be shifted to the Commission or its staff under any circumstances. SEC v. Great American Industries, 407 F. 2d 453, 457 (2d. Cir. 1968); See Boruski v. Division of

Corporation Finance of the U.S. Securities and Exchange Commission, 321 F. Supp. 1273, 1276 (S.D.N.Y. 1971); cf. Section 26 of the Exchange Act, 15 U.S.C. §78z.

52. With respect to a proxy statement, review by the Commission is neither necessary nor tantamount to a determination that that document is not false and misleading. Rule 14a-9(b)(17 C.F.R. 240. 14a-9(b)).

VIII. FURTHER EQUITABLE RELIEF

53. The Commission has requested, as further equitable relief, the appointment of additional independent directors to the Board of Directors and the appointment of an audit committee to Falstaff's Board of Directors to be composed of independent persons.

54. It is true that once equity jurisdiction has been properly invoked by a showing of securities law violations, the

Court possesses considerable latitude to fashion an appropriate remedy. See SEC v. Manor Nursing Centers, Inc., supra at 1103. However, in formulating such remedies, the Court should not, without considerable justification, impose a remedy which would in effect regulate areas traditionally left to internal corporate management. Cf. Superintendent of Insurance v. Bankers Life and Casualty Co., 404 U.S. 6, 12 (1971). Our review of the evidence leads us to conclude that Falstaff's internal corporate structure has not deteriorated to the point where a remedy such as that proposed by the Commission is warranted.

JUDGMENT

In light of the foregoing, the Court is granting permanent injunctive relief as set forth in the "JUDGMENT OF PERMANENT INJUNCTION AS TO DEFENDANT FALSTAFF

BREWING CORPORATION" filed herewith.

JUDGMENT OF PERMANENT INJUNCTION.

Plaintiff Securities and Exchange Commission ("Commission") having filed a complaint for injunctive and other relief (the "Complaint") and the Court having considered the pleadings and papers filed herein and having heard the trial of this matter and upon the findings of fact and conclusions of law reached by this Court and issued this date, the Court being fully advised in the premises:

I

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that Falstaff Brewing Corporation ("Falstaff") its officers, agents, servants, employees and attorneys, and those persons in active concert or participation with them, and each of them be, and they are hereby, permanently enjoined from, directly or indirectly in connection with the offer, purchase or sale of the securities of

Falstaff, its subsidiaries and affiliates, or of any other issuer, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange:

A. Employing any device, scheme, or artifice to defraud; or

B. Making any untrue statement of a material fact or omitting to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, concerning, but not limited to:

(1) The financial condition of Falstaff or any other issuer;

(2) The business operations of Falstaff or any other issuer;

(3) The present and prospective value of the securities of Falstaff or

any other issuers;

(4) The ownership and voting rights of the securities of Falstaff or any other issuer;

(5) The acquisition of any securities of Falstaff or any other issuer; and

(6) The dissemination of information with respect to Falstaff or any other issuer; or

C. Engaging in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in violation of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b))("Exchange Act") and Rule 10b-5 (17 C.F.R. §240.10b-5) thereunder; it is

II

FURTHER ORDERED, ADJUDGED AND DECREED that Falstaff, its officers, agents, servants, employees and attorneys, and those persons acting in active concert

or participation with them, and each of them be, and they are hereby, permanently enjoined from filing or causing to be filed with the Commission annual, current or other periodic reports with respect to Falstaff, its subsidiaries and affiliates, or any other issuer, which contain any untrue statement of material fact or omit to state any material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading or which omit any material fact required to be contained therein, in violation of Section 13(a) of the Exchange Act (15 U.S.C. §78m(a)) and Rules 12b-20, 13a-1, 13a-11 and 13a-13 (17 C.F.R. §§240.12b-20, 240.13a-1, 240.13a-11 and 240.13a-13 thereunder; it is

III

FURTHER ORDERED, ADJUDGED AND DECREED that Falstaff, its officers, agents, servants, employees and attorneys, and those persons in active concert or participation with them, and each of them be and they are hereby, permanently enjoined from, directly or indirectly with respect to securities of Falstaff, its subsidiaries and affiliates or any other issuer, by the use of the mails or by any means or instrumentality of interstate commerce, or of any facility of a national securities exchange, or otherwise:

A. Soliciting or permitting the use of the name of Falstaff to solicit, any proxy or consent or authorization with respect to any class of voting securities

of Falstaff, unless each person solicited is concurrently furnished or has previously been furnished with a written proxy statement conctaining the information specified in Schedule 14A (17 C.F.R. §240.14a-101); or

B. Using a proxy statement, information statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication in connection with the same meeting or subject matter which has become false or misleading, in violation of Section 14(a) of the

Exchange Act (15 U.S.C. §78m(a)) and Rules 14a-3 and 14a-9 (17 C.F.R. §§ 240.14a-3 and 240.14a-9) thereunder, it is

IV

FURTHER ORDERED, ADJUDGED AND DECREED that Falstaff within one hundred twenty (120) days after the entry of this Order or such later time as the Commission may permit, shall make such amendments and supplements to its existing filings with the Commission, as may be necessary or appropriate in order that such filings not contain any untrue statements of material fact or omit tc state any material fact requird to be stated therein or necessary to make any statement made in such filings not false or misleading in light of the circumstances under which

they were made; and it is

V

FURTHER ORDERED ADJUDGED AND DECREED that the Court shall retain jurisdiction of this action to implement and carry out the terms of this judgment.

There being no just reason for delay, the clerk of the Court is hereby directed to enter this Judgment forthwith.

Notice: This opinion is subject to formal revision before publication in the Federal Reporter or U.S. App. D.C. Reports. Users are requested to notify the Clerk of any formal errors in order that corrections may be made before the bound volumes go to press.

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 79-1467

SECURITIES AND EXCHANGE COMMISSION

v.

FALSTAFF BREWING CORPORATION
AND PAUL KALMANOVITZ, APPELLANTS

Appeal from the United States District Court
for the District of Columbia

(D.C. Civil Action No. 77-0894)

Argued February 12, 1980

Decided May 29, 1980

Alfred H. Moses, with whom *Jeffrey H. Howard* was on the brief, for appellants.

Rosalind C. Cohen, Special Counsel, Securities and Exchange Commission, with whom *Jacob H. Stillman*, Associate General Counsel, was on the brief, for appellee.

Bills of costs must be filed within 14 days after entry of judgment. The court looks with disfavor upon motions to file bills of costs out of time.

Before MCGOWAN, TAMM, and ROBB, *Circuit Judges.*

Opinion for the court filed by *Circuit Judge* TAMM.

TAMM, *Circuit Judge*: The Securities and Exchange Commission filed this action seeking to have the United States District Court for the District of Columbia enjoin the Falstaff Brewing Corporation and the chairman of its board and controlling stockholder, Paul Kalmanovitz, from future violations of certain provisions of the Securities Exchange Act of 1934 (Act), 15 U.S.C. §§ 78a-78hh (1976). After considering oral testimony, depositions, and documentary evidence, Judge Howard F. Corcoran held that both Falstaff and Kalmanovitz had violated the Act and issued the injunctions sought. *See SEC v. Falstaff Brewing Corp.*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,583 (D.D.C. 1978). Falstaff and Kalmanovitz appeal, and we affirm.

I. OVERVIEW

The facts of this case are intricate and will be developed more fully in discussing each challenge made to the district court's decision. For now, we shall summarize the overall factual background, the district judge's holding, and the grounds of appeal.

Falstaff, an independent, publicly owned brewer, suffered severe financial losses for several years in the late 1960's and early 1970's. In 1974 Falstaff sold its San Francisco brewery to the General Brewing Corporation, a company beneficially owned by Paul Kalmanovitz, a wealthy businessman active in the beer industry. General Brewing would continue to produce beer under the Falstaff name.

Following this transaction, Falstaff's management decided to probe Kalmanovitz to see if he was interested in investing in Falstaff itself. On March 10, 1975, Kal-

manovitz entered into an agreement with Falstaff under which he would invest $10 million in cash and personally guarantee another $10 million in loans. In return, he would receive preferred stock sufficient to give him a majority voting interest in the company, together with an option to purchase more. Falstaff sent a proxy statement to the company's shareholders, who approved the transaction at an April 28 meeting.

After assuming control of Falstaff, Kalmanovitz failed to report his stock acquisition to the Commission for more than one year. In addition, Falstaff failed to file certain required reports with the Commission and filed others that the Commission believed were materially misleading.

In 1977 Falstaff issued another proxy statement to its shareholders, seeking approval to pay dividends on Kalmanovitz's preferred stock in common stock rather than in cash. The Commission contends that this proxy statement misstated certain material facts and omitted others. The Commission instituted this action to block the 1977 shareholders' meeting and to obtain a permanent injunction against Falstaff and Kalmanovitz ordering them not to violate certain provisions of the Act in the future.

After reviewing the evidence, Judge Corcoran concluded that Falstaff and Kalmanovitz committed the following violations:

(1) The 1975 proxy statement was false and misleading, a violation of section 14(a) of the Act, 15 U.S.C. § 78n(a) (1976), and rules 14a-3 and 14a-9 thereunder, 17 C.F.R. §§ 240.14a-3, -9 (1979). Both defendants now concede that the 1975 proxy statement was deficient, and Falstaff admits its liability. Kalmanovitz, however, contests the district court's holding that he, too, is liable for this violation.

(2) Kalmanovitz failed to make a timely filing of a Schedule 13D reporting his acquisition of Falstaff stock and thus violated section 13(d) of the Act, 15 U.S.C. § 78m(d) (1976), and rules 13d-1 and 12b-20 thereunder, 17 C.F.R. §§ 240.13d-1, .12b-20 (1979). Kalmanovitz does not challenge this holding.

(3) Falstaff failed to file or filed inaccurate reports on Forms 8-K, 10-K, and 10-Q during 1975 and 1976, violations of section 13(a) of the Act, 15 U.S.C. § 78m(a) (1976), and rules 13a-1, 13a-11, 13a-13, and 12b-20 thereunder, 17 C.F.R. §§ 240.13a-1, -11, -13, .12b-20 (1979). The defendants, though conceding that one report was deficient, contend that they filed all other required reports and that all filings were materially correct. Kalmanovitz also argues that the district judge made insufficient findings to hold him liable for aiding and abetting Falstaff in these violations.

(4) The 1977 proxy statement was materially deficient in several respects, a further violation of section 14(a) and rules 14a-9 and 12b-20. Both defendants raise challenges to particular statements or omissions the court held were violations.

(5) Both defendants violated section 10(b) of the Act, 15 U.S.C. § 78j(b) (1976), and rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1979), through their errors in the 1975 and the 1977 proxy statements and in the 1975 and 1976 reports and through misstatements in a November 1975 letter that Kalmanovitz sent to Falstaff shareholders. Both defendants argue that the misstatements and omissions were immaterial and that the district judge was required to find that they acted with scienter.

On the basis of these and other findings, Judge Corcoran concluded that there existed a reasonable likelihood that the defendants would engage in further misconduct. He therefore enjoined them from violating these sections and rules in the future. Both defendants also challenge the injunctions.

We shall discuss, in order, the violations with regard to the 1975 proxy statement, the 1975 and 1976 reports, the 1977 proxy statement, and the section 10(b) violations. We then shall turn to the reasonable likelihood of further misconduct and the propriety of entering the injunctions.

II. The 1975 Proxy Statement

Falstaff and Kalmanovitz concede that the proxy statement mailed to shareholders in April of 1975 was materially false and misleading in several respects, and Falstaff now admits its liability for these deficiencies. Kalmanovitz, however, contests his liability. He argues that because he was not yet a shareholder, an officer, or a director of Falstaff, the district court should not have held that he violated the Act and the relevant Commission rules. We nevertheless agree with Judge Corcoran that Kalmanovitz, as well as Falstaff, is liable for the misstatements.

A. *The Facts*

At the time Kalmanovitz and Falstaff opened their negotiations early in 1975, Falstaff was in severe financial distress. It had lost $3.8 million in 1974. It owed $12.5 million in low-interest loans to two insurance companies and $16 million in notes and lines of credit to three banks, interest at 1½% above prime. In the fall of 1974, these institutional lenders demanded that Falstaff pool all its assets, aside from accounts receivable

and inventories, to secure the $28.5 million debt. In January 1975 the lenders executed a "Collateral Agency Agreement," under which they agreed among themselves to share all of Falstaff's payments on a pro rata basis. Falstaff's board of directors approved this arrangement on January 27, 1975. Later, on March 31, Falstaff acceded to the insurance lenders' demand that it acknowledge any failure to repay pro rata would constitute a default and thus would entitle them to call their loans immediately (the "March waivers").

In the meantime, Kalmanovitz and Falstaff completed arrangements for Kalmanovitz's investment in Falstaff. Kalmanovitz would purchase 100,000 shares of a new Class A preferred stock for $10 million, giving him a majority voting interest in Falstaff.[1] Additionally, Continental Can Company, a major supplier of cans to the brewery, had agreed to defer Falstaff's payment of $10 million in can purchases, provided that Kalmanovitz would personally guarantee the underlying note. Kalmanovitz agreed. Finally, Kalmanovitz received an option to purchase another 100,000 shares of a new nonvoting Class B preferred stock for $10 million in return for his guarantee on another $10 million in Falstaff accounts payable.

On March 10, 1975, Falstaff and Kalmanovitz signed an agreement reflecting these arrangements. The district court found that, at this time, Kalmanovitz already knew of the liens on Falstaff's assets and the pro rata restrictions in the Collateral Agency Agreement. He also knew by April 4 that Falstaff had agreed to the March waivers, including their provision that payment other than on a pro rata basis would be deemed a default

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[1] Each of the 100,000 shares would have 45 votes. Because there were slightly fewer than 4.5 million shares of common stock outstanding, the transaction would leave Kalmanovitz with 50.02% of the voting interest in Falstaff.

on the $12.5 million in insurance loans. Kalmanovitz nonetheless planned to use the $20 million raised by Falstaff in the transaction ($10 million from Kalmanovitz and $10 million from deferral of payments to Continental Can) to pay off the $16 million in high-interest bank notes, even though doing so would violate the March waivers and the Collateral Agency Agreement. Kalmanovitz believed that the bank loans, with their high interest rate, were a "cancer" on the company.[2]

Falstaff's directors approved the Kalmanovitz transaction on March 31, 1975, and called a shareholders' meeting for April 28 to ratify the arrangement. In early April, the directors mailed a proxy statement to the shareholders. Kalmanovitz had seen a first draft of the proxy statement on or before March 22 and read the final version shortly after its distribution. After the latter reading, he thought that the statement was fraudulent but elected to say nothing about it.[3]

Judge Corcoran also concluded that the proxy statement was materially deficient in several respects. First, it failed to disclose two potential conflicts of interest: (1) Kalmanovitz's beneficial ownership of General Brewing Corporation, which had purchased Falstaff's San Francisco brewery and was producing Falstaff beer, and (2) Kalmanovitz's agreement to guarantee the Conti-

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[2] Falstaff was paying approximately 11% on the bank loans as opposed to 6% on the insurance loans.

[3] Kalmanovitz contests this finding. At oral argument, counsel characterized Kalmanovitz's remarks as meaning that he thought the deal was fraudulent as to him, not as to the existing Falstaff shareholders. We do not believe, after examining the record, that the district court's finding was clearly erroneous. Moreover, we have difficulty understanding how a proxy statement could defraud a person who was not a recipient of it and who had more information than the statement contained.

nental Can credit. Second, the proxy statement, though mentioning the loans from the banks and the insurance companies, did not apprise the shareholders of the defaults and liens, the Collateral Agency Agreement, the March waivers, or Kalmanovitz's plan to pay off the bank loans despite these restrictions. Third, the proxy statement failed to disclose with sufficient clarity that approval of the sale of stock to Kalmanovitz would give him effective control of Falstaff and would dilute the present shareholders' control.[4]

Based on these facts, Judge Corcoran concluded that both Falstaff and Kalmanovitz had failed to provide all the information Schedule 14A requires for a proxy state-

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[4] The defendants challenge as clearly erroneous the district court's finding that the proxy statement did not disclose adequately Kalmanovitz's control and the dilution of the existing shareholders' interest. We disagree. Although on page 4 the proxy statement stated that Kalmanovitz would be entitled to name a majority of Falstaff's directors, *see* Joint Appendix (J.A.) at 225, no mention of this result appeared in the discussion of the proposed charter amendments, *see id.* at 228-30. Disclosures that Kalmanovitz would purchase 100,000 preferred shares, that each share would have 45 votes, and that 4,496,625 common shares with one vote each were outstanding were spread over two pages of small print. *See id.* at 228-29. Nowhere did the proxy statement tell the shareholder that a vote to approve the transaction was a vote to transfer control of his company to Kalmanovitz.

No one disputes that the transaction's giving Kalmanovitz majority control is a material fact. Although "corporations are not required to address their stockholders as if they were children in kindergarten," Richland v. Crandall, 262 F. Supp. 538, 554 (S.D.N.Y. 1967), disclosure may not be buried in a mass of information that, when pieced together, might give the correct impression. A court is not clearly erroneous when it finds inadequate a proxy statement that spreads over two pages the data necessary to calculate the impact of a proposed transaction on control of the company. *See* Gould v. American-Hawaiian Steamship Co., 535 F.2d 761, 774 (3d Cir. 1976).

ment[5] and had made omissions that rendered the proxy statement materially false and misleading. Therefore, they had violated section 14(a) of the Act and rules 14a-3 and 14a-9 thereunder.

B. *Kalmanovitz's Liability*

Kalmanovitz contests his liability under section 14(a) of the Act. He argues that because he was not yet part of Falstaff's management, which issued the statement, and because he neither drafted the statement nor controlled its contents, he was under no obligation to correct any false or misleading information it contained. We do not agree.

As the Supreme Court has said time and again, any effort to construe a statute, including the securities laws, must begin with the language of the statute itself. *E.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976). *Accord, e.g., Lewis v. United States*, 100 S. Ct. 915, 918 (1980). Section 14(a) of the Act forbids "any person . . . to solicit or to permit the use of his name to solicit any proxy" in violation of Commission rules. 15 U.S.C. § 78n(a) (1976).[6] By its express terms, section 14(a)

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[5] The current version of Schedule 14A appears at 17 C.F.R. § 240.14a-101 (1979).

[6] In full, this subsection reads:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title [Act § 12].

15 U.S.C. § 78n(a) (1976).

Rule 14a-3 requires every proxy solicitation to conform to Schedule 14A. In a solicitation by management for the annual

applies not only to one who himself solicits proxies but also to anyone who "permit[s] the use of his name" in the solicitation. Kalmanovitz's name appeared eleven times in the nine-page proxy statement, in three separate items. He saw a first draft over a week before it was issued and read the final version shortly after it was mailed to the shareholders. Thus, under the literal language of the statute, Kalmanovitz permitted his name to be used in the proxy solicitation.

Of course, the simple appearance of one's name in a proxy statement does not trigger liability for any misstatement appearing therein. Instead, there must have been "a substantial connection between the use of the person's name and the solicitation effort." *Yamamoto v. Omiya*, 564 F.2d 1319, 1323 (9th Cir. 1977). For example, this substantial connection is present in the case of director nominees listed in the proxy statement:

> [N]ominees h[o]ld out their names and reputations to shareholders as evidence that the group backing them [is] the proper choice to run the corporation.

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shareholders' meeting, the statement must be accompanied by an annual report that complies with the specifications of Form 10-K, with some additions. 17 C.F.R. § 240.14a-3(a)-(b) (1979). Rule 14a-9 provides in relevant part:

> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

Id. § 240.14a-9(a).

> Having put their reputations in issue, the nominees cannot divorce themselves from improper actions taken in the proxy battle by the participants acting under the banner of their names. Moreover, since the major object of the proxy contest [is] to install the nominees into positions where they would ostensibly control the corporation, all participants working for their election are in a sense agents of the nominees, and thus the nominees must be expected to assume some responsibility for the actions of their agents.

Chris-Craft Industries, Inc. v. Independent Stockholders Committee, 354 F. Supp. 895, 915 (D. Del. 1973).

We agree with the reasoning in *Chris-Craft* and believe it applies to the situation now before us.[7] Kalmanovitz's reputation as a businessman, his plans for Falstaff, and his other dealings that could create conflicts of interest were important to the existing shareholders, who were being asked to transfer control of the company to him. That the proxies nominally were sought by the management is not dispositive; in reality, it was Kalmanovitz who was seeking the shareholders' votes to approve his taking control. His connection with the transaction was more than substantial. It was pivotal. Thus, the district court properly concluded that he could be held liable for his failure to correct errors that he knew appeared in the proxy statement issued on his behalf.[8]

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[7] Kalmanovitz seeks to distinguish *Chris-Craft* because the directors' election there was contested. This difference in no way affects our analysis. The absence of an organized opposition does not reduce the obligation of proxy solicitors to be truthful and comprehensive in the material they distribute. Indeed, with no group actively fighting the transaction, solicitors arguably are subject to a greater duty: no opposition is presenting the other side.

[8] Kalmanovitz relies on the facts in Yamamoto v. Omiya, 564 F.2d 1319 (9th Cir. 1977), which articulated the "sub-

Our conclusion comports with the policy behind the regulation of proxy solicitations. In the words of Ferdinand Pecora, counsel to the Senate Committee on Banking and Currency when it considered the Act:

> I think [section 14(a)] mak[es] it possible for every stockholder to learn in advance of his giving a proxy what the proxy is sought for, whether the request for the proxy comes from the management group or whether it comes from a minority group who want to use the proxy. It enables every stockholder to act intelligently with regard to the giving of his proxy, instead of putting him in a position where he gives his proxy through the process of signing a blank check.

Stock Exchange Practices: Hearings Before the Sen. Comm. on Banking & Currency, 73d Cong., 1st Sess. (pt.

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stantial connection" standard, *see* p. 10 *supra*, to support his position. We do not believe that case is apposite here. In *Yamamoto*, the Court of Appeals for the Ninth Circuit refused to hold the purchaser of a building liable for errors in a proxy statement sent to the seller's shareholders seeking their approval of the sale. The court reasoned that the purchaser had no control over the statement's contents and that the identity of the purchaser probably did not induce shareholders to vote for the sale. *See id.* at 1323. In the case before us now, Kalmanovitz was seeking to take control of the company itself, and information about him and his plans certainly was material to the shareholder deciding whether to give his proxy to persons supporting the transaction.

Kalmanovitz also argues that the district court erred in remarking that the information relating to the Continental Can transaction and the plans to retire the high-interest debt, which the proxy statement failed to disclose, "was information which rested primarily with Kalmanovitz." SEC v. Falstaff Brewing Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,583, at 94,469 (D.D.C. 1978). We do not believe, however, that Kalmanovitz's relative knowledge is important; rather, what is relevant is Kalmanovitz's awareness of this information and his failure to disclose it when he concluded that the proxy statement was fraudulent.

16) 7716 (1934). Falstaff shareholders in effect were asked to sign just such a blank check when they received a proxy statement, nominally from the management, that failed to disclose material information needed for them to cast an intelligent vote. Permitting Kalmanovitz to escape liability would mean that anyone attempting to take control of a corporation could mislead the existing shareholders with impunity simply by finding a nominal solicitor willing to violate the law. The Supreme Court has written that "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)). Kalmanovitz's conduct falls within the purpose, as well as the literal language, of a statute designed to give shareholders complete and accurate information when voting on corporate policy. We therefore conclude that Judge Corcoran properly held him liable under section 14(a) and the Commission's rules thereunder.

III. Violations of Section 13(a)

The district court also held Falstaff and Kalmanovitz liable for failing to file required reports and for filing inaccurate reports with the Commission. Specifically, Falstaff did not file a Form 8-K when Kalmanovitz went forward with his plans and prepaid the bank loans, when the insurance lenders thereafter declared a default under the March waivers, or when Falstaff issued a note to Continental Can for the payment deferrals. A Form 8-K filed in January of 1976 noted the litigation with the insurance lenders but, in the district court's view, did not reveal adequately the basis of the action and thus was materially false and misleading. In addition, at no time

did Falstaff or Kalmanovitz correct the errors made in the 1975 proxy statement. Falstaff and Kalmanovitz challenge these conclusions and some of the facts underlying them. Kalmanovitz in addition asserts that Judge Corcoran's failure to make an explicit finding that he aided and abetted Falstaff's violations precludes any finding of personal liability on his part.[9]

A. *Current Reports on Form 8-K*

Section 13(a) requires all issuers subject to the Act's registration requirements to submit periodic reports to the Commission containing such information as the Commission may direct through its rules. 15 U.S.C. § 78m (a) (1976).[10] The Commission, pursuant to this au-

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[9] The district court also held that the defendants had violated rule 13a-13, 17 C.F.R. § 240.13a-13 (1979), and rule 12b-20, *id.* § 240.12b-20, with regard to Falstaff's filings of quarterly reports on Form 10-Q. We have discovered no findings of fact concerning the filing of Form 10-Q's, but the defendants have not challenged this absence. Therefore, we decline to comment on the correctness of this holding. We do note, however, that all Form 10-Q requires is a statement that the registrant has made all necessary reports during the past 12 months and has been subject to the reporting requirements for the past 90 days. SEC Form 10-Q, *reprinted in* 4 FED. SEC. L. REP. (CCH) ¶ 31,031 (1979). Any misstatement on this form thus would be cumulative of the errors and omissions found on Forms 8-K and 10-K.

[10] This subsection provides:

> Every issuer of a security registered pursuant to section 78*l* of this title [Act § 12] shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security—
>
> (1) such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an

thority, has directed every registrant to notify it on a Form 8-K of large acquisitions and dispositions of assets, declarations of bankruptcies or receiverships, director resignations, and other major corporate events whenever these events occur; other information must be reported annually on a Form 10-K. *See* 17 C.F.R. §§ 240.13a-1, -11 (1979).[11] Under rule 12b-20, a company filing a report must include such additional information as will make the filing not misleading under the surrounding circumstances. *Id.* § 240.12b-20.[12]

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application or registration statement filed pursuant to section 78*l* of this title, except that the Commission may not require the filing of any material contract wholly executed before July 1, 1962.

(2) such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe.

Every issuer of a security registered on a national securities exchange shall also file a duplicate original of such information, documents, and reports with the exchange.

15 U.S.C. § 78m(a) (1976).

[11] Rule 13a-1 requires a registrant to file an annual report on Form 10-K. Rule 13a-11 requires a Form 8-K whenever certain events listed in the form's instructions transpire. *See* text. For the current versions of these forms, see 4 FED. SEC. L. REP. (CCH) ¶¶ 31,001-04 (1979) (Form 8-K); *id.* ¶¶ 31,101-08 (1980) (Form 10-K).

[12] As a preliminary matter, we note that the defendants concede a Form 8-K filed in October of 1975 did not adequately discuss pending litigation between Falstaff and the insurance lenders and thus violated rule 12b-20. This Form 8-K mentioned that the company was the plaintiff in an antitrust and fraud action brought against the insurance lenders. It did not state, however, that Falstaff had filed this action to have

In January of 1976, Falstaff filed a Form 8-K stating that it had paid off the bank loans and had entered court seeking a declaration of the rights of the various parties to the insurance loans.[13] Judge Corcoran con-

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the court declare the Collateral Agency Agreement, the March waivers, and the lenders' declarations of default invalid.

In addition, we decline to rule on the defendants' contention that the bank and the insurance loans and the Continental Can credit were not securities and thus Form 8-K as it then read did not oblige Falstaff to report the payment of the bank loans, the insurance lenders' declaration of default, and the issuance and payment of the note to Continental Can. (Form 8-K at the time required reports only on changes and defaults on "securities.") The defendants, in their objections before the district court to the Commission's proposed conclusions of law, did not raise the issue of whether the loans and notes were securities. *See* J.A. at 187 (arguing only overtechnicality, immateriality, and ultimate disclosure). We will not permit them to embark on this theory for the first time on appeal. Judge Corcoran's ruling must stand.

[13] The Form 8-K read, in relevant part:

> Falstaff paid off all its outstanding bank loans during the summer of 1975, thereby eliminating more than $16,000,000 in high-interest indebtedness. Once Falstaff had made these payments, New York Life Insurance Company and Mutual Life Insurance Company of New York threatened suit based on Falstaff's failure to permit the insurance companies to share in these pre-payments according to pre-arranged terms set by these same companies. *Falstaff had never been in default on its payment obligation to these insurance companies.*
>
> In August, 1975, Falstaff filed an action for a declaratory judgment against the four banks and two insurance companies, asking the Court to determine the rights and duties of the parties under the various contracts relating to the Falstaff loans. Both the New York Life Insurance Company and the Mutual Life Insurance Company of New York responded by filing counter-claims against Falstaff. The suit alleges that Falstaff was in default under the terms of its promissory notes with the insur-

cluded that this statement violated rule 12b-20 because it failed to disclose that Falstaff had agreed to the pro rata repayment on March 31, 1975, and that Falstaff's prepayment of the bank loans was what triggered the insurance lenders to declare their loans in default. Falstaff and Kalmanovitz, however, believed that this information was obvious from the language of the completed form.

We believe Judge Corcoran properly found that the January 1976 Form 8-K failed to disclose needed information. The Form 8-K nowhere mentions that Falstaff itself had agreed to pro rata repayment. Instead, it states flatly that Falstaff "had never been in default" and then reports that the insurance lenders alleged Falstaff was in default. Joint Appendix (J.A.) at 340, *quoted in* note 13 *supra*. The omission of any description of the March waivers executed by Falstaff makes the Form 8-K misleading. Only by a painstaking reading could one perhaps infer that the prepayment was the ground of the default, thus making the suit more than a vexatious action brought by one group of lenders dissatisfied that another group had been prepaid. By failing to disclose in the Form 8-K material information necessary to make the statements in it not misleading, Falstaff and Kalmanovitz violated rule 12b-20.

B. *Annual Reports on Form 10-K*

In a description of its antitrust action against the insurance company lenders, Falstaff's 1975 Form 10-K stated:

> Current lenders are claiming default by the Registrant under convenants [*sic*] of the original lending

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> ance companies, and demands acceleration of the repayment of all outstanding principal under said notes.

J.A. at 340 (emphasis added).

> agreements and also a default resulting from an agreement dated March 25, 1975 requiring the Registrant to payoff its long-term lenders on a pro-rata basis, and are demanding acceleration of the repayment of all principal outstanding under said Notes.

J.A. at 285. The district court found this passage misleading because it did not disclose that Falstaff's prepayment of the bank loans had led the insurance lenders to declare a default. The court then concluded that the Form 10-K's violated rule 12b-20 by failing to describe adequately Falstaff's relations with its lenders, the litigation with them, the pro rata restrictions, the bank loans, and the subsequent declarations of default.

Again, we do not believe that Judge Corcoran's finding was clearly erroneous. The Form 10-K states only in the most general of terms the basis of the lenders' case, *i.e.*, Falstaff's alleged violation of the March waivers and the Collateral Agency Agreement; it does not discuss the nature of the violations or the events underlying the claimed breaches. Failure even to mention facts as material as Falstaff's own agreement to repay the loans pro rata misleads investors and shareholders by denying them critical information about major litigation and, indirectly, about the performance of the company's management. With the disclosure presented in a materially misleading way, we affirm the district court's holding that this Form 10-K violated rule 12b-20.[14]

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[14] The defendants assert that the omission of the Continental Can transaction was immaterial because Falstaff regularly purchased cans from Continental and the arrangement simply deferred payment. We disagree. The amount of the note ($11.6 million) and its term (two years) suggest that it was more than a routine payment scheme. We do not believe Judge Corcoran's finding was clearly erroneous.

The defendants also argue that failure to include the Continental Can transaction on the 1976 Form 10-K was immaterial because the loan was repaid fully in 1975. The district

C. *Kalmanovitz's Liability*

Kalmanovitz argues vociferously that even if the Form 8-K's and 10-K's violated the Act and the relevant Commission rules, the district court did not expressly make the findings of fact and conclusions of law necessary to render him liable as an aider and abettor.[15] To hold that a defendant aided and abetted another's violation, a court must conclude that a wrongful act occurred, that the defendant was aware of it, and that he knowingly and substantially participated in it. *Gould v. American-Hawaiian Steamship Co.*, 535 F.2d 761, 779 (3d Cir. 1976). Our previous discussion amply confirms that a variety of violations of the reporting requirements did indeed occur. The district court also found Kalmanovitz's participation in this wrongdoing to have been both knowing and substantial. Thus, we conclude he may be held liable despite the absence of an express conclusion of law in the district court's opinion.

In discussing the facts surrounding the filing of the Form 8-K's and 10-K's, the district court several times

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court's opinion is somewhat vague on this point. It nowhere expressly finds that this omission was material, but it lists the Continental Can transaction among several deficiencies that apply to both the 1975 and the 1976 Form 10-K's. *See* SEC v. Falstaff Brewing Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,583, at 94,462, 94,471 (D.D.C. 1978). Because this error is merely cumulative of the other deficiencies found in the 1976 Form 10-K, we do not believe it necessary to determine precisely what the district court held, for even if its conclusion were improper, remand on this point would be unnecessary.

[15] Kalmanovitz also raised the possibility that the district court may have been acting under § 20 of the Act, 15 U.S.C. § 78t (1976), which provides liability for controlling persons. The Commission has not pursued this alternative basis for liability before us, so we do not discuss it.

found Kalmanovitz to have been a knowing and active participant. First, on August 29, 1975, outside counsel to Falstaff sent Kalmanovitz a copy of a letter that expressed concern over Falstaff's compliance with the securities laws. The letter explicitly recommended filing a Form 8-K regarding the declarations of default. Second, Kalmanovitz directly participated in the decision not to include a description of the loan defaults in the 1975 Form 10-K but instead to mention them in the disclosure relating to the antitrust litigation. Third, Kalmanovitz knew that Form 8-K required a disclosure of all significant litigation. Fourth, Kalmanovitz participated in the drafting of the January 1976 Form 8-K with its insufficient description of the litigation. Fifth, Kalmanovitz at the time considered the acceleration of the insurance company loans, if enforceable, to be a substantial threat to Falstaff's financial future. Kalmanovitz does not claim that any of these findings is clearly erroneous.[16]

Despite these express findings of fact, Kalmanovitz argues that the district court could not hold him liable under section 13(a) without explicitly stating that he was an aider and abettor. Having reviewed Judge Corcoran's opinion thoroughly, we disagree. We do not believe that when a judge makes ample and unambiguous findings of fact, his conclusion that the defendant violated the law must be overturned simply because he did not state the theory he obviously was using *in haec verba*. The Commission charged Kalmanovitz in part on an aiding-and-abetting theory. *See* J.A. at 1 (complaint). The opinion of the district court laid all the necessary predicates for Kalmanovitz's liability under such a theory and then expressly concluded that he was liable. That it neglected to state explicitly one link in the chain is regrettable, but this omission does not undermine the

[16] We also note that Kalmanovitz signed all the forms actually filed.

chain, the validity of the link clearly implied, or the strength of the ultimate conclusion. We therefore affirm Kalmanovitz's liability under section 13(a) and rules 13a-1, 13a-11, and 12b-20.

Interpolating facts and legal theories from insufficiently thorough opinions is not an exact science, but this observation does not mean we cannot make inferences when the route to them is short and safe. We strongly believe that district courts should lay out their findings and conclusions clearly, and we will remand for illumination when we are left in the dark. Nevertheless, we may proceed when the light, though slightly dimmed, is nonetheless amply bright to guide us in our review. *See SEC v. Savoy Industries, Inc.*, 587 F.2d 1149, 1168 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979).[17]

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[17] Kalmanovitz cites *Savoy* in support of his position. We believe, however, that the situation that confronted us in *Savoy* differs markedly from the one before us now. The district court in *Savoy* had found that certain filings had been deficient and then had held the defendant liable, stating simply that the defendant's group had been in control. On appeal, we noted the absence of any findings of fact concerning the defendant's personal participation. 587 F.2d at 1170. We also described the absence of any findings of facts or conclusions of law pertaining to a good-faith defense under § 20(b) of the Act, 15 U.S.C. § 20t(b) (1976). 587 F.2d 1170-71. Our decision to remand rested on our inability to infer exactly what formed the basis of the district court's holding. Indeed, on another issue in the case, we held, "The absence of an express finding on the probability of future violations by the district court does not impair our ability to sustain the district court's injunction where the necessary factors are so obviously present." *Id.* at 1168.

Judge Corcoran's opinion contains explicit findings on Kalmanovitz's participation in and knowledge of the § 13(a) violations. No good-faith defense exists under that section. As we note in the text, findings are present on all the elements of aiding and abetting, followed by the ultimate conclusion of liability. All that is missing is a statement that

IV. THE 1977 PROXY STATEMENT

In April of 1977, Falstaff sent to its shareholders a proxy statement for its upcoming annual meeting.[18] The statement solicited proxies for the election of directors, including the reelection of Kalmanovitz, and for an amendment to the corporation's charter that would permit it to pay Kalmanovitz the dividends due on his preferred stock in common stock rather than cash. This transaction would increase Kalmanovitz's voting interest in Falstaff.

The district court found the 1977 proxy statement materially deficient in several respects. First, it did not disclose Kalmanovitz's voting control of Falstaff. Second, it did not detail (1) the number of common shares Kalmanovitz would receive under the proposed transaction, (2) the source of the common stock, (3) the amount payable to Kalmanovitz under the existing terms of the preferred stock, or (4) background information explaining how the proposal would conserve Falstaff's cash resources. Third, the statement referred to an audit committee that in fact never met. Fourth, it stated that the Commission had "no comment" on the proxy statement when, in fact, the Commission had informed Falstaff that it regarded the statement to be materially deficient.[19]

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aiding and abetting is the theory underlying the conclusion. This omission is a far cry from the multitude of missing findings and conclusions in *Savoy*.

[18] The meeting was not held. On May 10, the Commission staff notified Falstaff that it was authorized to institute this action. The Commission filed a motion for preliminary relief to block the meeting on May 27. By stipulation entered June 1, Falstaff agreed not to hold the meeting or solicit proxies for it until the district court ruled on the granting of interim relief.

[19] Falstaff filed a preliminary copy of the proxy statement with the Commission about March 28, 1977. *See* 17 C.F.R.

Falstaff and Kalmanovitz argue that the proxy statement adequately disclosed Kalmanovitz's control and potential conflicts of interest and that the references to the audit committee were not false and misleading. They contend any omissions were trivial items of little concern to investors.[20] We disagree and affirm Judge Corcoran's

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§ 240.14a-6(a) (1979). The Commission advised Falstaff on April 6 that the statement was materially deficient and that any dissemination of it would be at Falstaff's own risk. J.A. at 776 (letter from Falstaff's general counsel acknowledging receipt of this message and asking for information on the specific nature of the deficiencies). The Commission declined to give detailed comments. *See id.* § 202.3(a) (Commission ordinarily does not give comments "when the deficiencies appear to stem from careless disregard of the statutes and rules or a deliberate attempt to conceal or mislead"). Instead of reporting that the Commission believed the statement was materially deficient, Falstaff simply added the following rider to the statement, which it then mailed:

> In accordance with the rules and regulations of the United States Securities and Exchange Commission, this Notice of Annual Meeting of Shareholders and Proxy Statement was submitted to the SEC in advance of mailing. *The SEC has taken a "no comment" position relative to this proxy statement.* The Company, in the interest of its shareholders, has proceeded with the mailing of this Proxy Statement without having received any formal comments from the SEC. In the event that the SEC later objects to any item or items to be voted upon, the votes as tabulated by the Company respecting any such item or items will not become effective until such time as such objections have been resolved.

J.A. at 253 (emphasis added). Obviously, this remark substantially misrepresented the Commission's position. The defendants do not appear to challenge the district court's finding that this passage was false and misleading.

[20] The district court also held that Falstaff violated § 14(a) and the relevant rules by failing to correct in the 1977 proxy statement the errors made in the 1975 proxy statement. The defendants argue that the rules do not require correction of

findings and his conclusion that the omissions violated section 14(a) and rules 14a-9 and 12b-20.

A. *Kalmanovitz's Control*

The district court held that the 1977 proxy statement was materially false and misleading, in part because it did not disclose adequately that Kalmanovitz controlled Falstaff and its board. The court believed that a clear statement of his control was needed to place the board's recommendation of a stock dividend to Kalmanovitz in perspective: shareholders then could vote on the proposal knowing not only that Kalmanovitz had a vital interest in the approval of the stock dividend but also that he controlled the board that ultimately would vote on it.

The 1977 proxy statement said only: "Mr. Paul Kalmanovitz, who is Chariman of the Board of the Company, has a direct interest in this matter as a result of his beneficial ownership of 100% of the Class A Preferred Stock outstanding." J.A. at 253. This passage does not suggest that he also held a majority voting control, could name a majority of the directors, and in fact was in command of the company and its board. Thus shareholders might not know Kalmanovitz controlled the very management that was recommending approval and soliciting the common stockholders' proxies. We therefore agree that Falstaff's failure to make this potential conflict clear rendered its comments on the conflict of in-

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all misstatements and omissions made in earlier solicitation materials. We need not reach this difficult question, however. The 1977 proxy statement contained ample mistakes for the district court to support its conclusion that it violated the Act and the rules. Failure to correct the 1975 errors, if a violation, is purely cumulative. Thus, even if we were to reverse this holding, multiple violations with regard to the 1977 proxy statement and other areas would remain. A reasonable likelihood of future violations still would be present.

terest misleading. The defendants thereby violated section 14(a) and rules 14a-9 and 12b-20.[21]

B. *The Audit Committee*

The 1977 proxy statement also referred to an audit committee consisting of Kalmanovitz and two other directors. Judge Corcoran found that in fact this committee never met or functioned. He concluded that mentioning this nonexistent committee created the false impression that the board of directors was exercising careful oversight of the company's finances; the statement, therefore, was false and misleading.

The defendants attempt to undermine this finding by submitting that even if not functioning as a formal committee, the named individuals were overseeing the company's finances and thus the statement was not false. We nevertheless believe that the district court's finding was not clearly erroneous. The existence of a committee implies a structured investigation and analysis of a company's fiscal welfare. Informal procedures may be adequate, but formal entities such as committees create at least the impression of great care and precision through detailed review and oversight. Stating that an audit committee, with its implication of careful oversight, existed when it did not thus is misleading, particularly when the proxies are being sought for a meeting at which directors will be selected; *i.e.*, when one major

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[21] The district court also held that the failure to disclose Falstaff's control violated item 5 of Schedule 14A, 17 C.F.R. § 240.14a-101 (1979). The defendants argue that the rule governs only changes in control since the beginning of the last fiscal year. *See id.* (item 5(f)). Because we have concluded that the failure to describe Kalmanovitz's control violated the Act and rules 14a-9 and 12b-20, we need not decide whether this omission also violated Schedule 14A. The Schedule 14A violation would be simply a different characterization of the same underlying misconduct.

issue before the shareholders is whether to retain the current management. Therefore, we agree that this statement in the 1977 proxy materials was false and misleading and that its inclusion violated the Act and the relevant rules.

V. Section 10(b) and Rule 10b-5

The district court also held that Falstaff and Kalmanovitz had violated section 10(b) of the Act, 15 U.S.C. § 78j (1976),[22] and rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1979).[23] These provisions prohibit manipu-

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[22] This section reads, in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1976).

[23] This rule reads:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

[Continued]

lative and deceptive practices in the purchase and sale of securities. The district court found that Falstaff and Kalmanovitz engaged in such practices in submitting a misleading proxy statement to shareholders in 1975, in failing to file or filing inaccurate reports, in misleading Falstaff shareholders in a 1975 letter,[24] and in distribut-

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[23] [Continued]

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1979).

[24] This letter, sent over Kalmanovitz's signature as the new chairman of Falstaff's board, stated in part:

For your information, Falstaff paid off all its outstanding bank loans in full during the summer of this year, thereby eliminating more than $16,000,000 in high interest indebtedness. When Falstaff made these payments, New York Life Insurance Company and Mutual Life Insurance Company of New York threatened Falstaff with a lawsuit because we did not permit the insurance companies to share in these prepayments according to the terms of an agreement which the lenders had made between themselves. However, Falstaff had never been in default of its payment obligations to these insurance companies, and never will be.

Falstaff has been advised by its attorney, Mr. Joseph L. Alioto of San Francisco, that the agreement between the insurance companies and the banks to share any loan prepayments constituted a clear violation of the antitrust laws, threatening the financial stability of Falstaff. Based upon this advice, Falstaff is now in the process of filing an antitrust lawsuit against the New York Life Insurance Company, the Mutual Life Insurance Company of New York, and four major banks, alleging that these lenders agreed among themselves to allocate lending opportunities, to pool their interests in certain lending agreements with Falstaff, and to pool any prepayments by Falstaff under those lending agreements, all to the financial detriment of Falstaff. Your management has

ing another misleading proxy statement in 1977.[25] The defendants challenge the materiality of the omissions and errors and also contend that the district court did not make a proper finding of scienter, which, they argue, is a prerequisite to liability in a Commission enforcement action. We affirm the district court's determinations in all respects.

A. *Materiality*

We need pause but briefly on the defendants' arguments that the misstatements and omissions were immaterial. Materiality is a question of fact, and information is material if "there is a substantial likelihood that a reasonable shareholder would consider [information] important in deciding how to vote." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Our discussions of the violations of sections 13(a) and 14(a) and the rules thereunder amply demonstrate that Falstaff and Kalmanovitz indeed made false and misleading statements and omitted information necessary to make

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instructed its attorneys to prosecute these matters vigorously to the full extent of the law.

J.A. at 772. The district court found that these remarks were misleading in failing to disclose Falstaff's acquiescence to the Collateral Agency Agreement or its execution of the March waivers. We do not believe this finding is clearly erroneous.

[25] On three occasions, we have declined to resolve the defendants' challenges to specific findings because the district court's decisions that violations occurred in these instances were simply cumulative of other findings that we have affirmed. *See* notes 14, 20 & 21 *supra*. Liability under § 10(b) and rule 10b-5 depends in part, at least arguably, upon these violations. Nevertheless, there remain ample other violations that we have affirmed or that the defendants have conceded underlying the § 10(b) and rule 10b-5 liability, and any error regarding these three violations would be harmless.

other remarks not false or misleading. Their attempt to contest materiality here is meritless.

B. *Scienter*

The Supreme Court has held that in private actions under rule 10b-5, the plaintiff must prove that the defendant acted with scienter, *i.e.*, "intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 & n.12 (1976). The Court has not yet decided whether the Commission must prove scienter in an administrative enforcement proceeding. *See id.* at 193 n.12.[26] Judge Corcoran declined to decide this question, for he found that the Commission had proved scienter on the facts before him.

Falstaff apparently does not challenge the finding of scienter on its part. Kalmanovitz, however, argues that the district court could not find that he acted with scienter. We disagree. In discussing scienter, the district court specifically restated its earlier conclusion that Kalmanovitz had known of the material omissions and misstatements in the 1975 proxy statement, a conclusion that we have affirmed, *see* pp. 9-13 *supra*. It also reiterated that Kalmanovitz had known of the errors in the 1977 proxy statement. Moreover, in conjunction with the violations of section 13(a), the district court concluded that Kalmanovitz had known of the omissions and failures to file. *See* pp. 19-20 *supra*.

Kalmanovitz contends that scienter requires an inquiry into "the defendant's state of mind—his subjective belief as to the legality of his action . . . ." Brief of Appellants at 41. We strongly disagree. Knowledge means awareness of the underlying facts, not the labels

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[26] This issue is presently before the Court in Aaron v. SEC, 48 U.S.L.W. 3563 (U.S. No. 79-66) (argued Feb. 25, 1980), *on cert. to* 605 F.2d 612 (2d Cir. 1979).

that the law places on those facts. Except in very rare instances, no area of the law—not even the criminal law—demands that a defendant have thought his actions were illegal. A knowledge of what one is doing and the consequences of those actions suffices. We therefore hold that because Kalmanovitz knew the nature and consequences of his actions, he acted with scienter.[27]

VI. The Injunctions

The district court entered orders enjoining Falstaff and Kalmanovitz, their agents, and their employees from committing further violations of the securities laws. Because prospective relief is designed to prevent future misconduct rather than to compensate for or to punish past violations, *see Hecht Co. v. Bowles*, 321 U.S. 321, 329 (1944), *cited in SEC v. Savoy Industries, Inc.*, 587 F.2d 1149, 1169 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979), the court must determine " 'whether the defendant's past conduct indicates . . . that there is a *reasonable likelihood* of further violation[s] in the future.' "

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[27] Several courts of appeals have held that a reckless disregard for the consequences of one's actions is enough to demonstrate scienter in an action under rule 10b-5. *See, e.g.*, Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Coleco Industries, Inc. v. Berman, 567 F.2d 569, 574 (3d Cir. 1977), *cert. denied*, 439 U.S. 830 (1978); First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978); Sanders v. John Nuveen & Co., 554 F.2d 790, 792 (7th Cir. 1977). *Accord*, Nassar & Co. v. SEC, 566 F.2d 790, 794-95 (D.C. Cir. 1977) (Leventhal, J., concurring). *Cf.* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (reserving question of whether scienter includes recklessness). We need not decide whether recklessness alone suffices, for we have held that Kalmanovitz acted knowingly. Of course, because knowledge embraces recklessness, our conclusion that Kalmanovitz acted knowingly a fortiori includes a conclusion that he acted at least recklessly.

SEC v. Savoy Industries, Inc., 587 F.2d at 1168 (quoting *SEC v. Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 99 (2d Cir. 1978) (emphasis in original)). Falstaff and Kalmanovitz challenge the injunctions by reiterating earlier assertions of incorrect analysis of the evidence, by raising new objections to certain additional findings of fact, and by arguing that the Commission did not demonstrate a reasonable likelihood of further violations. We conclude that Judge Corcoran acted properly.

A. *Factual Basis of the Injunctions*

In addition to the violations discussed above,[28] the court relied on additional factors in deciding whether to issue the injunctions. Specifically, it found that Falstaff had continued to seek proxies under the 1977 statement despite warnings from the Commission and Falstaff's employees of the statement's serious inadequacies. Moreover, Falstaff board members failed to file certain disclosure forms under the Act, and Falstaff had falsely represented to the court that its brewer's bond had been cancelled on account of the litigation in this case. The defendants contend that these findings by the district court could not support the injunctions. We disagree.

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[28] Our decision not to reach three issues because the violations involved would simply be cumulative, *see* notes 14, 20, 21 & 25 *supra*, also does not hamper our upholding the injunctions. Because they are cumulative, we do not believe that these particular violations were the proverbial straws that broke the camel's back, and the absence of an express finding that the remaining violations would have been enough does not undermine the reasonable likelihood of future misconduct. *See* SEC v. Savoy Indus., 587 F.2d 1149, 1168 (D.C. Cir. 1978) ("absence of an express finding on the probability of future violations by the district court does not impair our ability to sustain the district court's injunction where the necessary factors are so obviously present"), *cert. denied*, 440 U.S. 913 (1979).

1. *Disregard of Warnings*

The defendants do not dispute the district court's finding that they continued to solicit proxies with the 1977 statement even after the Commission informed the company that it regarded the document as being materially deficient. Instead, they argue that a judge may not take this conduct into account in evaluating the likelihood of future violations. They believe that a court may not fault a party for persisting in its belief that its conduct is lawful and acting on that behalf, at least until a court holds the party in violation of some legal duty.

In the present context, we believe that the district court could consider Falstaff's proceeding with the 1977 proxy statement. That document, we have concluded, was indeed deficient. The Commission so warned Falstaff. The company's own employees questioned the adequacy of the disclosures. Failure to follow Commission—and internal—advice may not be a violation itself, but it surely suggests that in the future, apprised again of potential violations, Falstaff might proceed undeterred as it did in 1977. Ignoring warnings of possible violations is relevant to the particular task facing a judge in ruling whether to grant an injunction; namely, assessing the likelihood that a defendant will violate the law again.

2. *Reports by Directors*

Falstaff also maintains that the failure of certain executives to file reports under section 16(a) of the Act, 15 U.S.C. § 78p(a) (1976),[29] does not demonstrate a

[29] This provision requires officers, directors, and persons having a beneficial ownership totalling 10% or more of any class of equity securities to file reports on any acquisitions or changes in outstanding amounts of those securities. 15 U.S.C. § 78p(a) (1976). The report is filed on Commission Form 3 or 4. *See* 17 C.F.R. § 240.16a-1 (1979).

propensity for Falstaff to violate the Act in the future. Falstaff characterizes the violations as overly technical and not probative. Again, we must conclude that Judge Corcoran could consider this information and decide that it indicated a likelihood of future misconduct. Whether due to ignorance, neglect, or conscious decision, noncompliance with section 16(a) does evince a disregard of the securities laws that may manifest itself in noncompliance elsewhere. Moreover, these violations involved several members of Falstaff's board other than Kalmanovitz. Misconduct by multiple directors surely suggests that Falstaff might continue shirking its legal duties.

3. *Brewer's Bond*

Falstaff, in a letter from counsel dated July 1, 1977, informed the district court that "the bond which is required of every brewery by federal law to ensure payment of taxes has been cancelled by Falstaff's bonding company as a result of this suit." J.A. at 817. The district court found that this representation was false and used it as further evidence pointing to a likelihood of future violations.

The defendants argue that the statement was not false and that its use was unfair surprise. We disagree. Although Falstaff points to several factors that it claims make this representation accurate in context, we have found nothing in the record indicating that any insurer actually had cancelled a brewer's bond.[30] Moreover, Fal-

[30] Falstaff and Kalmanovitz try to explain away this statement by pointing to three facts: one carrier's statement in May of 1977 that it would require more liquid collateral, Falstaff's having called several other carriers in search of better terms, and subsequent calls from brokers seeking information about this litigation. We do not see how the defendants can combine these factors to support a statement that any insurer actually cancelled a bond due to the filing of this action. The remark in the letter is clearly false.

staff itself raised the bonding issue, Kalmanovitz discussed the bonding situation at some length in his deposition, and the Commission also deposed officials of bonding companies. We can find no element of unfair surprise in using a misrepresentation made directly to the court when both parties delved into the underlying facts in discovery and in exhibits filed during the proceedings.[31]

B. *Likelihood of Future Violations*

The defendants' major objections come in the district court's analysis of the facts and its conclusion that both defendants are reasonably likely to violate the securities laws again. Principally, the defendants argue that despite their number, all the charges ultimately stem from the mistakes made in the 1975 proxy statement. The management that prepared that statement is no longer with Falstaff; therefore, Falstaff is not likely to make the same errors in the future. Moreover, Kalmanovitz, due to his age and his purported good-faith efforts to comply with the securities laws, is not likely to commit further violations. We find that these objections lack merit and therefore affirm the granting of the injunctions.

1. *Relation to the 1975 Proxy Statement*

We cannot agree with the defendants that all the relevant errors relate to the 1975 proxy statement and thus

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[31] The defendants also argue unfair surprise with regard to the district court's finding that an October 1975 letter sent by Falstaff to the Commission was false in stating that Falstaff had retained new accountants. In its brief, the Commission pointed to a trial brief in which it brought this letter to the court's attention. The defendants have not responded to this revelation, and we take this silence as meaning that they no longer contend Judge Corcoran's use of this letter was unfair. In any event, because the letter was used only to suggest that the defendants had made misstatements to the Commission, it is purely cumulative of the rest of the evidence. *Cf.* pp. 35-36 *infra* (Kalmanovitz's good faith).

to management no longer with Falstaff. Many of the violations result from failure to file accurate reports with the Commission after the new management took over. *See* pp. 13-19 *supra*. In addition, the new management prepared the 1977 proxy statement, *see* pp. 22-26 *supra*, and is responsible for the misstatements in the November 1975 letter to Falstaff shareholders, an October 1975 letter to the Commission, and the July 1977 letter to the district court concerning brewer's bonds. Kalmanovitz, we have held, was himself liable for the 1975 proxy violations, and the failures to file under section 16(a) are violations by the present directors. Although the sins of the corporate fathers should not be visited upon succeeding generations of management, *see SEC v. Cenco, Inc.*, 436 F. Supp. 193, 199 (N.D. Ill. 1977), the transgressions here were the acts and omissions of persons currently in control of Falstaff. Ample evidence of repeated misconduct supports the district court's remark that these errors "have not been isolated or random, but rather have been part of a chronic pattern of violations, which has continued up to the present time." *SEC v. Falstaff Brewing Corp.* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,583, at 94,472 (D.D.C. 1978). Judge Corcoran's conclusion that these factors indicate a reasonable likelihood of future violations and his concomitant decision to issue an injunction were proper.

2. *Kalmanovitz's Good Faith*

At oral argument, counsel contended vigorously that we should vacate the injunction against Kalmanovitz because any errors on his part occurred due to ignorance and not to bad faith.[32] He always sought to comply with

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[32] In our discussion of scienter, we held that knowledge of one's actions and their consequences is all the law requires; a demonstration of a subjective belief that those actions are

the law, according to counsel; he simply misunderstood his legal duties.[33] Assuming arguendo that this assessment of Kalmanovitz's state of mind is correct, it does little to advance his case. Material misstatements and omissions in proxy materials and failures to file required reports are no less harmful to the investing public when the violator, knowing the nature and the consequences of his actions, does not obtain adequate legal advice than when he ignores the advice he receives. Here, Kalmanovitz saw omissions and misstatements and did nothing to correct them. He failed to file required reports. He construed Commission refusals to give detailed comments on documents it stated were materially deficient as being equivalent to its having said "no comment." Whether actuated by bad faith or simple ignorance of the law, he violated the law, and the pattern of past violations indicates that he is reasonably likely to do so in the future. Judge Corcoran acted properly in enjoining Kalmanovitz from future violations.[34]

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illegal is unnecessary. *See* pp. 29-30 *supra*. Subjective assessments of legality may be relevant, however, in determining whether there is a likelihood that the defendant will violate the securities laws again and, therefore, in whether an injunction should be issued.

[33] Counsel stated at oral argument that Kalmanovitz misunderstood that when the Commission refused to cooperate by pointing out the errors it was not saying "no comment." We find it difficult to believe this assertion when the Commission expressly stated that it had found the 1977 proxy statement to be materially deficient and that issuing it would be at Falstaff's own risk. Kalmanovitz did not react to the Commission's failure to give detailed comments by seeking further legal advice. Instead, he had Falstaff issue the proxy statement as it read, adding only the misleading "no comment" paragraph. *See* note 19 *supra*.

[34] Kalmanovitz also points to his age—he is in his mid-70's—as undermining a likelihood of future violations. We will not overturn the district court's injunction, however,

VII. Conclusion

Our review of this case demonstrates clearly that both Falstaff and Kalmanovitz violated the securities laws in numerous ways. Some charges, to be sure, overlap, but the record nonetheless reveals multiple occasions on which they withheld information, failed to file required reports, or filed inaccurate ones. In light of these violations, the district court acted properly in enjoining both Falstaff and Kalmanovitz from further misconduct. Therefore, the judgments of the district court are

Affirmed.

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solely on speculation about the length of Kalmanovitz's tenure at Falstaff or his longevity.

STATUTES

15 U.S.C. §78J(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any National Securities Exchange . . .

(b) to use or employ, in connection with the purchase or sale of any security registered on the National Securities Exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. §78M(a)

Every issuer of a security registered pursuant to §781 of this Title shall file with the Commission in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of its investors and to insure fair dealing in the security -

(1) Such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included or filed with an application or registration statement filed pursuant to §781 of this Title, except that the Commission may not require the filing of any material contract wholly executed before July 1, 1962.

(2) Such annual reports (and such copies thereof) certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof) as the Commission may prescribe.

15 U.S.C. §78N(a)

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a National Securities Exchange or otherwise, in contravention of such rules and regulations and the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to §781

of this Title.

17 C.F.R. 240.10b-5(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any National Securities Exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made not misleading, or

(c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

CERTIFICATE OF SERVICE

I certify that on the 21st day of August, 1980, I caused to be served on Jacob H. Stillman, Associate General Counsel, Securities and Exchange Commission, 500 North Capital Street, Washington, D.C. 20549 and the Solicitor General of the United States, Department of Justice, Washington, D.C. 20530, three copies of appellants' Petition for Writ of Certiorari by placing same in the United States Mail at St. Louis, Missouri, with first class postage thereon fully prepaid.

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